85-668

No.

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

WARREN G. WHEELER, JR., JEAN M. WHEELER,
JAMES J. McLAUGHLIN, JR., And
MARY K. McLAUGHLIN,

Petitioners,

v.

THE UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

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20 October 1985

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I

QUESTIONS PRESENTED

1. Whether a person may be taxed, under the Constitution and Section 61 of the Internal Revenue Code, upon "income" which he "generated" but never received, over which he had no dominion, which he was prohibited from receiving, and which he never could have received even if he had so willed.

2. Whether a person ["Taxpayer"] may be taxed, under the Constitution and Section 61 of the Internal Revenue Code, upon amounts which he never could have himself received and which were paid to a third party, where that payment did not satisfy any legal liability of Taxpayer and did not relieve Taxpayer of any legal obligation.

3. Whether employee-parents are denied the equal protection of the laws by being subjected to income taxes when their children receive employer-provided college scholarships, while other provisions of the Internal Revenue Code exempt from income taxes college faculty employees whose children receive employer-provided college scholarships.

4. Whether an individual taxpayer is deprived of procedural due process of law by opinions, decisions, and judgments of the United States Claims Court and the United States Court of Appeals For The Federal Circuit which fail to recognize the existence of, cite, or even mention, contrary decisions of the Supreme Court of the United States and decisions to the contrary of other United States Courts of Appeals, but rather completely disregard those contrary decisions.

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THE UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

Warren G. Wheeler, Jr., Jean M. Wheeler, James J. McLaughlin, Jr., and Mary K. McLaughlin ["Taxpayers"], petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Federal Circuit in this case.

OPINIONS BELOW

The opinion of the Court of Appeals (Appendix A, *infra*, A1-A25) is reported officially at 768 F.2d 1333 and, unofficially at 85-2 USTC ¶ 9571 and at 56 AFTR2d 85-5577.

The opinion of the United States Claims Court, Chief Judge Alex Kozinski presiding, was delivered orally from the bench at conclusion of the trial; no written opinion ever was prepared. A copy of the entire transcript of the afternoon session of 1 August 1984 is included herein as Appendix C, *infra*, A27-A194. That session consisted of arguments of counsel, sundry questions asked by Chief Judge Kozinski, and, finally, the oral opinion of Chief Judge Kozinski.

JURISDICTION

The judgment of the Court of Appeals (Appendix B, *infra*, A26) was entered on 25 July 1985. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

CONSTITUTIONAL PROVISIONS, STATUTES, AND REGULATION INVOLVED

The provisions of the Constitution of the United States which are involved are the following:

Article I, Section 8, Clause 1

"The Congress shall have Power to lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and Provide for the Common Defence of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States."

Due Process Clause of the Fifth Amendment

"No person shall * * * be deprived of life, liberty, or property, without due process of law; * * *"

Sixteenth Amendment

"The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration."

The provisions of the Internal Revenue Code of 1954, 26 U.S.C., which are involved are:

Section 1(a)

"There is hereby imposed on the taxable income of every married individual * * * who makes a single return jointly with his spouse * * * a tax determined in accordance with the following tables * * *."

Section 61. Gross Income Defined

"Except as otherwise provided in this subtitle, gross income means all income from whatever source derived including (but not limited to) the following items:

"(1) Compensation for services, including fees, commissions, and similar items; * * *"

Section 63. Taxable Income Defined.

"(a) Corporations. * * *

"(b) Individuals

* * * [T]he term 'taxable income' means gross income minus the deductions allowed by this chapter."

Section 117. Scholarships and Fellowship Grants.

"(a) General Rule.

In the case of an individual, gross income does not include—(1) any amount received at an educational organization described in section 170(b)(1)(A)(ii), * * *"

Section 170. Charitable, Etc. Contributions And Gifts.

[Section 170(b) * * * (1) * * * (A) * * *]

"(ii) an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its education activities are regularly carried on, * * *"

The provision of the Regulation, 26 C.F.R., which is involved is:

Section 1.117-3 Definitions

"(a) Scholarship. A scholarship generally means an amount paid or allowed to, or for the benefit of, a student, whether an undergraduate or a graduate, to aid such individual in pursuing his studies. The term includes the value of contributed services and accommodations (see paragraph (d) of this section) and the amount of tuition, matriculation, and other fees which are furnished or remitted to a student to aid him in pursuing his studies. The term also includes any amount received in the nature of a family allowance as a part of a scholarship. However, the term does not include any amount provided by an individual to aid a relative, friend, or other individual in pursuing his studies where the grantor is motivated by family or philanthropic considerations. *If an educational institution maintains or participates in a plan whereby the tuition of a child of a faculty member of such institution is remitted by any other participating educational institution attended by such child, the amount of the tuition so remitted shall be considered to be an amount received as a scholarship."* [Emphasis Supplied.]

STATEMENT OF THE CASE

The complaints in this case were filed in the United States Claims Court, the court of first instance, on 22 and 23 June 1983. That court had jurisdiction of the actions under Sections 1491 and 1346(a)(1) of Title 28 of the United States Code entitled "Judiciary and Judicial Procedure" (28 U.S.C. §§ 1491 and 1346(a)(1)). The complaints asserted claims against the United States for the recovery of federal income taxes alleged therein to have been erroneously or illegally assessed or collected.

The two complaints filed in the respective cases by Taxpayers (the Wheelers in Claims Court Case 412-83T, the McLaughlins in Claims Court Case 414-83T) included the following identical paragraph:

> "32. Each of the claims for refund—that for 1975 and that for 1976—included the following statement:
>
> "Statement"
>
> "The deficiency assessed against Taxpayers was based upon an alleged increase in their 1975 and 1976 incomes received by their adult children [child] from an Educational Benefit Trust which had been established by South Bend Tribune which changed its name to Schurz Communications, Inc. in 1976.
>
> "The amounts paid to Taxpayers' adult children [child] were not included in their [his] parents' incomes for 1975 and 1976. Taxpayers received legal advice that those amounts were not includable in their incomes because (1) Taxpayers never received anything; (2) Taxpayers never had a right to receive anything; and (3) Taxpayers did not receive any economic benefit when amounts were paid from the trust for educational benefits for their children [child].
>
> "This claim for refund, filed on Form 1040X in accordance with the Commissioner's Regulations, is based upon the fact that the IRS erred in assessing a deficiency against Taxpayers based upon amounts received from the Trust by their children [child]."

The South Bend Tribune ["South Bend"] was organized as an Indiana corporation in 1873. Educo, Inc. ["Educo"] has been engaged since its inception in 1967 in designing, implementing, and administering college educational benefit plans for corporate employers. On 1 June 1975, South Bend and Educo entered into an "Educo Plan" agreement (Appendix F, *infra,* A199-A215)

South Bend never bargained to any extent with any of its employees—including Mr. Wheeler and Mr. McLaughlin—about its Educo Plan or the inclusion or exclusion of any children of employees in that plan; and neither Mr. Wheeler nor Mr. McLaughlin could have done anything to have included or excluded their children in or from that plan.

Neither Mr. Wheeler nor Mr. McLaughlin received any amounts from South Bend's Educo Trust; neither had anything to do with payments of educational benefits to his enrolled child; and neither could have done anything or refrained from doing anything which could have given either of them a power or interest in South Bend's Educo Trust.

Neither Mr. Wheeler nor Mr. McLaughlin obligated himself, by contract or otherwise, to pay for any part of the college education of his enrolled child. Finally, under Indiana law (Taxpayers were all residents of Indiana) a parent has no duty to provide even minor children with college educations.

In its Brief For The Appellee filed in the Court of Appeals, Respondent advanced three primary arguments in support of its case: (1) Generators of income may be taxed on the income flowing from their efforts; (2) Generators of income who know that third parties will receive amounts because of their efforts also are properly taxable under the anticipatory assignment of income principle; (3) Garden variety employees [*i.e.,* all employees except college faculty employees] are not denied equal protection of the laws because the government's decision to exempt college faculty employees from tax when *their* children receive employer-supplied scholarships is a rational one.

REASONS FOR GRANTING THE WRIT

I

The Court of Appeals Decision—Holding That One Who "Generates" Income By Performing Services May Be Taxed When Amounts Are Received By A Third Party Because Of Those Services—Directly Conflicts With This Court's *First Security Bank* Decision And Also Directly Conflicts With Decisions Of The Courts Of Appeals For The Fifth, Sixth, And Tenth Circuits

The Court of Appeals decision accepted Respondent's theory of this case which was expressed as follows at page 26, footnote 6, of the Brief For The Appellee which was filed on 14 February 1985 in the Court of Appeals:

> "* * * Congress plainly has the power to tax personal service income to the person who performs the services generating such income, and Congress has done just that in Section 61(a)(1).* * * "

That theory and the Court of Appeals decision directly conflicts with this Court's decision in *Commissioner* v. *First Security Bank of Utah,* 405 U.S. 394, 406 fn 22, 417. Justice Powell for the Court wrote [405 U.S. at 403]:

> "We know of no decision of this Court wherein a person has been found to have taxable income which he did not receive and which he was prohibited from receiving. In cases dealing with the concept of income, it has been assumed that the person to whom the income was attributed could have received it. The underlying assumption always has been that in order to be taxed for income, the taxpayer must have complete dominion over it. 'The income that is subject to a man's unfettered command and that he is free to enjoy at his option may be taxed to him as his income, whether he sees fit to enjoy it or not.' * * * "

Justice Marshall, dissenting, carefully distinguished a Section 61 case—such as this one—from a Section 482 case such as *First Security Bank* [405 U.S. at 410]:

> "This is not a case involving independent companies or private individuals where we must scrupulously avoid taxing someone on money he will never receive regardless of his will in the matter."

This Court's *First Security Bank* decision affirmed that of the Tenth Circuit: *First Security Bank of Utah* v. *Commissioner,* 436 F.2d 1192 (10th Cir. 1971). In reversing a Tax Court decision favorable to the Commissioner, the Tenth Circuit rejected the argument that one should be taxed because his services generate income which benefits another albeit "but for" those services there would be no income [436 F.2d at 1197]:

> "The Commissioner now urges on us the generation of business theory. He says in his brief that 'the effect of the Commissioner's allocation is to compensate Utah Bank and Idaho Bank for their efforts in generating and processing the credit insurance.'
>
> "Generation of income differs from assignment of income. It is fundamental that a taxpayer cannot assign a portion of his income in order to avoid tax liability on it. *** Also the power to dispose of it is the equivalent of ownership. *** These principles are grounded on rights in or flowing from income. ***

The Sixth Circuit followed this Court's *First Security Bank* decision in *Salyersville National Bank* v. *United States,* 613 F.2d 650 (1980). The question presented there was whether the Commissioner erred by attributing commissions for credit life insurance received by a bank's president to the bank itself. A United States District Court had upheld the Government's argument that the *First Security Bank* case is inapplicable because the Salyersville Bank was not barred by state law from becoming an insurance agent. In reversing, the Sixth Circuit rejected the government's argument that "the taxpayer bank had a duty to qualify as an insurance agent so that it could have legally received the income" and, further, held that "the fact that taxpayer may have had the power to enable it to receive

the income legally does not require that it exercise that power." *613 F.2d at 655-656.*

The Fifth Circuit joined the Sixth and Tenth with its decision in *Bank of Coushatta* v. *United States,* 650 F.2d 75 (5th Cir. 1981). In holding that a bank was not liable for federal income tax on credit life insurance commissions which had never been actually or constructively received by the bank, the Fifth Circuit also rejected the government's attempted distinction between legal and factual disability [650 F.2d at 77]:

> "The Supreme Court [in *First Security*] clearly did not hold that a showing that it would be illegal to receive commissions is essential for a plaintiff to prevail in a similar situation. Rather, the fact that the banks could not legally have received the commissions was cited as proof that the funds were not diverted away from them by the holding company. The issue in this case, then, is whether the Bank of Coushatta *received* the Commissions, actually or constructively, as income.
>
> "There is no showing of any kind that the Bank ever received any commissions as *income* under §61. 'Income' has been defined as 'all accessions to wealth, clearly realized, and over which the taxpayer has complete dominion.'* * *
>
> "Since the Bank never actually or constructively received the funds, it is irrelevant whether their receipt of the funds would have been illegal. ***"

II

The Court Of Appeals Decision Holding That There May Be A Taxable Economic Benefit Even If A Taxpayer Is Not Thereby Relieved Of A Legal Obligation By The Third Party Payment Conflicts With Fundamental Decisions Of This Court

The genesis of the economic benefit theory of taxation is *Old Colony Trust Company* v. *Commissioner,* 279 U.S. 716, 729.

The American Woolen Company had adopted a resolution which authorized direct payment by the company of "*** any and all income taxes *** payable upon the salaries of all the officers of the company." This Court held that payment by the employer of income taxes assessable against the employees constituted additional taxable income to the employees because "*** [t]he discharge by a third person of an obligation to him is equivalent to receipt by the person taxed."

The definitive pronouncement by this Court establishing the outer limits of taxable economic benefits is *Commissioner* v. *Hansen,* 360 U.S. 446. The *Hansen* case established the principle that a fund will be vested in a taxpayer for income tax purposes at the time it is established for the exclusive purpose of either being transferred to him at a future time or being then applied to pay and discharge him from his legal obligations. In explaining why the establishment of "reserve accounts" was taxable to automobile dealers even though they might never themselves receive anything, Justice Whittaker wrote [360 U.S. at 465, 466]:

> "It follows that only one or the other of two things can happen to the dealer's reserve account: (1) the finance company is bound to pay the full amount to the dealer in cash, or (2) if the dealer has incurred obligations to the finance company under his guaranty endorsement, or contract of sale, of the installment paper, the finance company may apply so much of the reserve as is necessary to discharge those obligations and is bound to pay the remainder to the dealer in cash."
>
> "In any realistic view we think that the dealer has 'received' his reserve account whether it is applied, as he authorized, to the payment of his obligation to the finance company, or is paid to him in cash."

III

The Court Of Appeals Improperly Applied A "Rational Basis" Test Rather Than A Classification Standard In Holding That Petitioners Had Not Been Denied Due Process By Respondent's Differential Taxation Of Corporate Employees

It is a denial of equal protection to discriminate between members of an indistinguishable class where that discrimination is not justified by a compelling governmental interest. *Shapiro* v. *Thompson,* 394 U.S. 618, 627. If a class of taxpayers is integral, it is a violation of due process to break the class up into sub-classes, subject to differential taxation, even if that sub-classification might find some empirical support for its sub-grouping. *Weinberger* v. *Wiesenfeld,* 420 U.S. 636, 645.

An improper tax classification will deny a member of the discriminated-against sub-class of equal protection even if he has been taxed in strict accordance with a taxing statute, but others have been taxed at lesser rates contrary to the statute. *Sioux City Bridge Company* v. *Dakota County, Nebraska,* 260 U.S. 441, 445-446; *Cumberland Coal Co.* v. *Board of Revision,* 284 U.S. 23, 28; *Iowa-Des Moines National Bank* v. *Bennett,* 284 U.S. 239, 247.

Corporations constitute an integral class distinct from individuals for tax purposes, *Lehnhausen* v. *Lake Shore Auto Parts Co.,* 410 U.S. 356, 365, but members of that class cannot be subdivided into sub-classes of foreign corporations and domestic corporations and taxed differentially. *Southern Railway Company* v. *Greene,* 216 U.S. 400, 412, 417; *Hanover Fire Insurance Company* v. *Harding,* 272 U.S. 494, 516; *Concordia Fire Insurance Company* v. *Illinois,* 292 U.S. 535, 549; *Wheeling Steel Company* v. *Glander,* 337 U.S. 562, 571-572; *Whyy, Inc.* v. *Borough of Glassboro,* 393 U.S. 117, 120. The *Whyy* case rejected the argument that the tax should be upheld because "the classification is not wholly irrational." *393 U.S. at 119.*

Two important federal tax cases of this Court distinguish the different equal protection inquiries mandated by income-inclusion cases—such as this one—and deduction cases. *National Life Insurance Company* v. *United States,* 277 U.S. 508, 519, held that the Revenue Act of 1921 denied equal protection to life insurance companies by subjecting them to a tax on a portion of their interest income from tax exempt securities while exempting from such a tax all other taxpayers. Justice McReynolds, who had authored the Court's opinion in *National Life,* also wrote for a unanimous Court in *Denman* v. *Slayton,* 282 U.S. 514. At issue there was a different provision of the 1921 Revenue Act which denied a deduction for interest on indebtedness incurred or continued to purchase or carry tax exempt securities. In upholding the classification against an equal protection challenge, the Court distinguished *National Life* [282 U.S. at 519]:

> "The circumstances disclosed in *National Life Insurance Co.* v. *United States* were radically different from those now presented, and the doctrine upon which that cause turned does not control the present one. The respondent here was not in effect required to pay more upon his taxable receipts than was demanded of others who enjoyed like incomes solely because he was the recipient of interest from tax-free securities***. While guaranteed exemptions [*i.e.,* deductions] must be strictly observed, this obligation is not inconsistent with reasonable classification designed to subject all to the payment of their just share of a burden fairly imposed."

More recently, this Court recognized that there is a significant facet of the equal protection issue in addition to the question of "fairness." *Minneapolis Star and Tribune Company* v. *Minnesota Commissioner of Revenue,* 460 U.S. 575, 585:

> "*** A power to tax differentially, as opposed to a power to tax generally, gives a government a powerful weapon against the taxpayer selected."

IV

The Court Of Appeals' Failure To Cite, Mention, Or Even Recognize The Existence Of, Any Of The Conflicting Decisions Of This Court And Of Other Courts Of Appeals Is Such A Departure From The Accepted And Usual Course Of Judicial Proceedings As To Call For An Exercise Of This Court's Power Of Supervision

All of the cases which directly conflict with the decision of the Court of Appeals here—*First Security Bank, Salyersville, Bank of Coushatta, Old Colony Trust,* and *Hansen*—were carefully presented and relevantly analyzed in Petitioners' briefs which were filed in the Court of Appeals. Not a single one of those cases, however, was cited or mentioned by the Court of Appeals in its opinion (Appendix A, *infra,* A1-A25). The question is whether a failure to deal with contrary precedent and overriding legal principles meets the high standards of judicial integrity which this Court should promote in our federal judicial system.

Roscoe Pound, in his book *The Spirit Of The Common Law* (Marshall Jones Company, Boston, 1921), had this to say on the point [*Id.* at 182-183]:

> " * * * The doctrine of precedents means that causes are to be judged by principles reached inductively from the judicial experience of the past, not by deduction from rules established arbitrarily by the sovereign will. * * * [183] The common-law doctrine * * * must be left to the disciplined reason of the judges, and we must find in the criticism of the reported decision by bench and bar in other cases our assurance that they will be governed by reason and that the personal equation of the individual judge will be suppressed. * * * "

Similarly, Justice Felix Frankfurter celebrated Judge Learned Hand's craft of judging, on Judge Hand's seventy-fifth birthday [60 Harv.L.Rev. 325 at 326 (1947)]:

> " * * * [S]o long as we shall continue to conceive of law not as the disguised manifestation of mere will but as

> the effort of reason to discover justice, the body of his opinions will be an enduring source of truth-seeking and illumination. His insights, the morality of the mind which respects those insights, the beauty with which they are expressed, make them so. And this is true even when he deals with issues which to meager perceptions appear meager. * * * "

There Justice Frankfurter spoke as a friend but he also had something to say on the subject as a judge [*Communist Party of the United States* v. *Subversive Activities Control Board*, 351 U.S. 115, 124]:

> " * * * [A]dministration of justice is certainly one of the most cherished aspects of our institutions. Its observance is one of our proudest boasts. This Court is charged with supervisory functions in relation to proceedings in the federal courts. * * * Therefore, fastidious regard for the honor of the administration of justice requires the Court to make certain that the doing of justice be made so manifest that only irrational or perverse claims of its disregard can be asserted."

CONCLUSION

There is a compelling public interest in the issue posed by this case. A proper decision of it—in accord with its particular facts and the law properly applicable to them—assuredly would encourage United States business corporations to adopt scholarship programs like the South Bend Educo Plan. The consequent corporate funding of such programs dramatically could advance the cause of higher education in our democratic society.

The Petition For A Writ Of Certiorari should be granted.

Respectfully Submitted,

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20 October 1985

APPENDICES

APPENDIX A

OPINION OF THE UNITED STATES COURT OF APPEALS

768 F.2d 1333-1337

Warren G. WHEELER, Jr., Jean M. Wheeler, James J. McLaughlin, Jr., and Mary K. McLaughlin,

Appellants.

v.

The UNITED STATES, Appellee.

Appeal No. 85-533.
United States Court of Appeals, Federal Circuit.
July 25, 1985.

Taxpayers brought action for refund of income taxes assessed upon amounts paid by their employers' education benefits trust toward college education of taxpayers' children. The United States Claims Court, Kozinski, C.J., ruled in favor of Government, and taxpayers ap-

pealed. The Court of Appeals, Friedman, Circuit Judge, held that: (1) amounts paid for college education of taxpayers' children by trust constituted taxable compensation to taxpayers, and (2) taxation of those amounts did not deprive taxpayers of equal protection of laws in violation of due process clause of Fifth Amendment.

Affirmed.

1. Internal Revenue K 3150

"Compensation for services," includable in gross income for tax purposes, covers any economic or financial benefit conferred in any form on employee unless it is specifically exempted by Internal Revenue Code. 26 U.S.C.A. § 61(a).

See publication Words and Phrases for other judicial constructions and definitions.

2. Internal Revenue K 3157

Amounts paid for college education of taxpayers' children by educational benefits trust established by taxpayers' employer constituted taxable compensation to taxpayers, notwithstanding that payments went directly to children; payments conferred economic benefit upon taxpayers by providing some financial support for children which parents would otherwise have had to furnish. 26 U.S.C.A. § 61(a).

3. Internal Revenue K 3560

First principle of taxation is that income is taxed to person who earns it.

4. Internal Revenue K 3022

Congress may provide tax benefit for particular class of taxpayers provided classification bears rational

relation to legitimate governmental purpose. U.S.C.A. Const.Amend. 5.

5. Constitutional Law K 48(6)

Presumption of constitutionality of tax benefit created by Congress for particular class of taxpayers is extremely difficult to overcome. U.S. C.A. Const.Amend. 5.

6. Constitutional Law K 213.1(2)

As long as there is rational basis for distinction made by statute, basis for distinction need not appear on face of regulation, implementing legislation, or history of provision in order to satisfy equal protection strictures. U.S.C.A. Const. Amends, 5, 14.

[768 F.2d 1334]

7. Constitutional Law K 286
Internal Revenue K 3151

Taxation of amounts paid for

college education of taxpayers' children by education benefits trust established by taxpayers' employer did not deny taxpayers equal protection of laws in violation of due process clause of Fifth Amendment; there was rational basis for differing treatment of those benefits and tuition remission benefits which were nontaxable. U.S.C.A. Const.Amend. 5; 26 U.S.C.A. § 117(a).

Paul A. Teschner, Teschner Professional Corp., Chicago, Ill., argued for appellants.

Bruce Ellisen, Tax Div., Dept. of Justice, Washington, D.C., argued for appellee. With him on the brief were Glenn L. Archer, Jr., Asst. Atty. Gen., Michael L. Paup and Richard Farber.

Before FRIEDMAN, NIES and NEWMAN, Circuit Judges.

FRIEDMAN, Circuit Judge.

This is an appeal from a judgment of the United States Claims Court dismissing the appellants' tax refund suits covering federal income taxes for the taxable years 1975 and 1976. The Claims Court held that amounts paid by an employer's educational benefits trust to the appellants' children for college expenses were properly includible in the appellants' gross income. We affirm.

I

The appellants Mr. Wheeler and Mr. McLaughlin were employed by the South Bend Tribune Corporation (South Bend)

during the years in issue. Mr. Wheeler was executive vice president, and Mr. McLaughlin was personnel director.

In 1975, South Bend entered into a college educational benefit plan agreement with Educo, Inc. (Educo), which provided funds for the college expenses of the children of certain key employees. South Bend made the arrangement "for the purposes of retaining such present employees, of attracting future employees, and generally to increase employee loyalty to Employer."

The plan provided for annual payments to the children of $2,000 toward their college expenses, with a total maximum payment of $8,000 per child. South Bend made sufficient contributions to the trustee of the plan to provide the funds to make the payments.

Payments were made from the trust fund directly to the child or to the child's creditors, and the employees had no right to receive any of the money in the trust or to control its disposition. If an employee left South Bend, the entitlement of his children to receive payments under the plan terminated.

The plan was conceived as an employment incentive to obtain and retain the services of key personnel. South Bend's board of directors selected the employees whose children would be eligible for the benefits. Of the 800 to 900 employees, only 16 employees in high level positions were designated for participation in 1975.

During each of the years 1975 and 1976, the trustee of the plan paid $2,000 toward the college expenses of

James Wheeler, the son of the appellants Warren and Jean Wheeler, and the same amount toward the college expenses of Elizabeth McLaughlin, the daughter of appellants James and Mary McLaughlin. The Commissioner of Internal Revenue determined that these amounts were includible in the appellants' gross income and assessed deficiencies in their federal income taxes for 1975 and 1976. The Wheelers and McLaughlins paid the deficiencies and filed claims for refund, which were disallowed. They then filed refund actions in the Claims Court, which were consolidated for trial.

Ruling from the bench, the Claims Court followed the Seventh Circuit's decision in Armantrout v. Commissioner, 570 F.2d 210 (7th Cir. 1978), and held that the payments to the children were compensation to Messrs. Wheeler and

McLaughlin and therefore constituted taxable income to them in the years in which the payments were made. The court further held that

[768 F.2d 1335]

such taxation of those benefits did not deny the appellants equal protection of the laws in violation of the due process clause of the fifth amendment.

II

[1] Section 61(a) of the Internal Revenue Code of 1954 defines gross income to include "compensation for services." This covers any economic or financial benefit conferred in any form on the employee unless it is specifically exempted by another section of the Code. Ritter v. United States, 393 F.2d 823, 183 Ct.Cl. 875 (Ct.Cl.), cert. denied, 393 U.S. 844, 89 S.Ct. 127, 21 L.Ed.2d 115 (1968).

[2] The Educo plan benefits that the Wheeler and McLaughlin children received were compensation for the services their fathers rendered to South Bend. The payments to the children conferred economic benefit upon their parents by providing some of the financial support for the children's college education that the parents themselves otherwise would have had to furnish. As the Claims Court noted, Mr. Wheeler and Mr. McLaughlin "testified that they were concerned about their children's college education and that they would have contributed to it, and did contribute to it, regardless of the payments made by Educo."

The appellants stress that they had no legal obligation to pay for their children's college education. This fact is immaterial in determining whether the payments to the children constituted compensation to the fathers because it conferred

an economic benefit on them. As the Claims Court correctly pointed out, "for middle class and for upper middle class individuals, as these plaintiffs obviously were, college has become more than a luxury. College for one's children has become, these days, a real necessity. Certainly something that every parent considers very carefully providing for his or her children."

The appellants provided financial support for their children's college education. There is no reason to believe that if children had not received benefits under the Educo plan they would not have attended college. As South Bend's chief financial executive stated, the educational benefits plan "was a part and parcel of the entire benefits of being employed by the South Bend Tribune."

From the viewpoint of South Bend, the Educo plan also was part of the compensation it paid to the key employees whose children were selected for the plan. The plan was designed to enable the company to retain existing employees, to attract new ones, and to increase employee loyalty to the company. One of its purposes was to "free up" the "concern" of "top employees" about their children's college, at least in part. The plan covered only a small number of key employees. Although South Bend did not bargain directly with the employees over the benefits they would receive under the plan, those benefits obviously were factors the company took into account in determining compensation. Moreover, South Bend initially considered the value of the employee's services to it in deciding which employees to include under the plan.

[3] The fact, which the appellants stress, that the educational payments were made to the children and not to the employees is immaterial. It is the first principle of taxation that "income is taxed to him who earns it." United States v. Basye, 410 U.S. 441, 449, 93 S.Ct. 1080, 1085, 35 L.Ed.2d 412 (1973); Commissioner v. Culbertson, 337 U.S. 733, 739-40, 69 S.Ct. 1210, 1212-13, 93 L.Ed. 1659 (1949).

The appellants conceded at oral argument that if the payments had been made to them as reimbursement for the college expenses they had incurred, the payments would have been part of their gross income. The result should be no different because the company instead routed the payments directly to the children. The situation is analogous to attempts to avoid taxation by the anticipatory

assignment of income, which "have frequently been held ineffective as means of avoiding tax liability." Basye, 410 U.S. at 450, 93 S.Ct. at

[768 F.2d 1336]

1086. The Tax Court and the Seventh Circuit have viewed an almost identical Educo plan, and the Fifth Circuit has viewed a similar plan, as involving an impermissible assignment of income. Armantrout v. Commissioner, 67 T.C. 996 (1977), aff'd. 570 F.2d 210 (7th Cir. 1978); Saunders v. Commissioner, 720 F. 2d 871 (5th Cir. 1983).

The appellants argue that this court's decision in Greensboro Pathology Associates v. United States, 698 F.2d 1196 (Fed. Cir. 1982), requires a contrary conclusion. Greensboro dealt with the tax consequences to the employer of an educational

Benefits trust similar to the Educo plan. This court held that the benefits plan was a "welfare benefits plan" and not a plan of deferred compensation" under section 404 of the Code, such as stock options or annuitites. The result was that the employer could deduct its payments to the trust when it made them as a business expense under section 162, instead of deferring the deduction under section 404 until the payments were made to the employee. Id. at 1203.

As the court recognized in Greensboro in distinguishing Armantrout, "the tax consequences to the employee-recipients of an educational benefit plan" is an entirely different question from "the tax consequences to the employer" of such a plan. 698 F.2d at 1200, n.3, emphasis in original. The tax consequences to the employee have nothing

to do with the timing of the employer's deduction. Whether a particular plan is viewed as in the "nature of deferred compensation" or as a welfare type benefit is immaterial in determining whether payments by the plan constitute income to the employee. This court recognized that "[a]ll types of fringe benefit plans have elements of compensation," Id. at 1200, and characterized the educational plan as involving "benefits provided the employees." Id. at 1203.

III

Alternatively, the appellants contend that the assessment of taxes on the education benefits denies them the equal protection of the laws in violation of the due process clause of the fifth amendment. They point to section 1.117-3(a) of

the Treasury Regulations, 26 C.F.R. §1.117-3 (a) (1984), which excludes from the parents' gross income tuition remission benefits provided for the children of college faculty members. The appellants argue that the educational benefits at issue here are the same as the exempted tuition remission benefits and that the equal protection clause bars the disparate tax treatment of the two categories of benefits.

Gross income generally does not include any amount received "as a scholarship" at an educational institution. 26 U.S.C. § 117(a) (1982). Treasury Regulation section 1.117-3(a) defines "scholarship" as including certain tuition remission benefits:

> If an educational institution maintains or participates in a plan whereby the tuition of a child of a faculty member of

> such institution is remitted by any other participating educational institution attended by such child, the amount of the tuition so remitted shall be considered to be an amount received as a scholarship.

This provision was taken directly from the language in the Committee Reports on the 1954 Code, which indicated that Congress intended "scholarship" to cover such tuition remission. H.R. Rep. No. 1337, 83d Cong., 2d Sess. at A37, reprinted in 1954 U.S. Code Cong. & Ad. News 4017, 4173-74; S.Rep. No. 1622, 83d Cong., 2d Sess. at 188, reprinted in id. at 4621, 4823. In 1984, Congress enacted a new section 117(d) which in effect codifies and broadens the above regulation. Deficit Reduction Act of 1984, Pub.L. No. 98-369,

§ 532, 98 Stat. 494 (to be codified at 26 U.S.C. § 117(d)).

Contrary to the appellants' contention, the tuition-remission benefits that are thus made nontaxable are not the same as the cash educational benefits of the present case. Under the remission plan, no money is paid to the child or the parent/faculty member.

[4, 5] Congress has "especially broad latitude in creating classifications and dis-

[768 F.2d 1337]

tinctions in tax statutes." Regan v. Taxation With Representation, 461 U.S. 540, 547, 103 S.Ct. 1997, 2002, 76 L.Ed.2d 129 (1983). See Madden v. Kentucky, 309 U.S. 83, 87-88, 60 S.Ct. 406, 407-408,

84 L.Ed. 590 (1940). Congress may provide a tax benefit for a particular class of taxpayers provided the classification bears a rational relation to a legitimate governmental purpose. Regan v. Taxation With Representation, 461 U.S. at 547, 103 S.Ct. at 2002. The presumption of constitutionality is extremely difficult to overcome. "The burden is on the one attacking the legislative arrangement to negative every conceivable basis which might support it." Madden v. Kentucky, 309 U.S. at 88, 60 S.Ct. at 408.

[6] The issue this is whether there is a rational basis for different treatment of the tuition remission benefits exempted by regulation and the educational benefits at issue here. The basis for the distinction need not appear on the face of the regulation, the implementing legislation, or the history of the provision. First National Bank of Oregon v.

United States, 571 F.2d 21, 25, 215 Ct. Cl. 609 (1978). "A statutory discrimination will not be set aside if any stated fact reasonably may be conceived to justify it." McGowan v. Maryland, 366 U.S. 420, 426, 81 S.Ct. 1101, 1105, 6 L.Ed.2d 393 (1961). The same principle applies in dealing with a Treasury regulation, where there is "long-standing precedent against invalidating on equal protection grounds a Federal tax regulation such as the one in question here." First National Bank, 571 F.2d at 25.

One rational basis here is the difference between the direct cash payment by the employer to children attending college and the remission of tuition charges by an educational institution other than the one that employs the parent. The administrative difficulty in valuing such noncash benefits may be substantial.

Another distinction is that the tuition remission programs are available to a large number of employees of an educational institution, whereas the Educo benefits are limited to a small number of key employees. In recently enacting a "fringe benefits provision" as part of the Deficit Reduction Act of 1984, which continues the exclusion for tuition remission programs, Congress attempted to "set down clear guidelines in the area of noncash compensation." H.R. Rep. No. 432 (Pt. 2), 98th Cong., 2d Sess. 1590 (1984) U.S. Code Cong. & Admin. News 1984, pp. 697, 1214. In so doing, Congress made clear that nondiscrimination is "an important common thread among the types of fringe benefits which are excluded" from taxation. Id. at 1592, U.S.Code Cong. & Admin. News 1984, p. 1216. To be exempt from taxation, tuition remission benefits

may not be restricted to "officers, owners, or highly compensated employees" of an educational institution. Deficit Reduction Act, § 532 (to be codified at 26 U.S.C. § 117(d)). Congress rationally may have decided to limit tax-exempt status to those educational benefits (tuition remission) for which it believed there was less likelihood of tax avoidance than in the case of direct case benefits.

Finally, Congress could have reasonably decided to exempt tuition remissions for children of college faculty members as a way of promoting higher education by encouraging qualified people to enter and to remain in the academic teaching profession despite low earnings.

[7] The taxation to the appellants of the educational benefits paid to their children did not deny the appellants equal protection of the laws in violation of the due process clause of the

fifth amendment.

CONCLUSION

The judgment of the United States Claims Court is affirmed.

AFFIRMED.

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

WARREN G. WHEELER, JR.,
JEAN M. WHEELER,
JAMES J. McLAUGHLIN, JR., and
MARY K. McLAUGHLIN,

Appellants,

v. NO. 85-533

THE UNITED STATES,

Appellee.

JUDGMENT

ON APPEAL from the United States Claims Court This CAUSE having been heard and considered, it it ORDERED and ADJUDGED; AFFIRMED.

DATED July 25, 1985

ENTERED BY ORDER OF THE COURT
George E. Hutchinson, Clerk

/s/ George E. Hutchinson
Clerk

ISSUED AS A MANDATE: August 16, 1985
COSTS: Against, Appellants
PRINTING----------$25.60
TOTAL----------$25.60

APPENDIX C

OFFICIAL TRANSCRIPT OF PROCEEDINGS
OF THE AFTERNOON SESSION HELD AT
CHICAGO, ILLINOIS, ON WEDNESDAY
1 AUGUST 1984

[Claims Court Appendix, Pages A128-A224]

[Chief Judge Kozinski, the trial judge, did not write an opinion in the case but rather ruled orally from the bench at the conclusion of the trial. Following is the complete transcript of the afternoon session of 1 August 1984 which consists of arguments of counsel and Chief Judge Kozinski's opinion. The complete transcript of the afternoon session is included on the assumption that some of the reasons given by Chief Judge Kozinski during oral argument are relevant to his decision.]

OFFICIAL TRANSCRIPT

Before the

UNITED STATES CLAIMS COURT

Case No. 412-83T
&
414-83T

In the Matter of:

WARREN G. WHEELER, JR., and JEAN M. WHEELER,

Plaintiffs,

vs.

THE UNITED STATES,

Defendant.

****

JAMES T. McLAUGHLIN, JR., and MARY McLAUGHLIN,

Plaintiffs,

vs.

THE UNITED STATES,

Defendant.

Place: Chicago, Illinois

Date: Wednesday, August 31, 1984

* * *

[A128]

AFTERNOON SESSION

MR. BLANCATO: All rise.

Court is again in session.

THE COURT: Please be seated.

As I recall, before lunch, both sides submitted their case and we are here for argument.

Mr. Teschner. [Counsel For Plaintiffs].

MR. TESCHNER: I decided what I would do is briefly go through and review the high points of a couple of our memoranda and refer to a few cases, which I think are directly in point of the government's theory of economic benefit.

Our plaintiffs' memorandum of fact and law was dated May 9 and filed May 10 with the Court. We cited just a few cases there. The principal ones would be First Security Bank of Utah, which we believe is the one which directly supports us. Greensboro Pathology Associates, which

the Federal Circuit reversed in 1982, holding that a similar type educational benefit plan was not a plan of deferred compensation.

We also cited Judge Willi's decision in the Court of Claims where he did hold that these were deferred compensation plans and he cited Armantrout and Grant Jacoby.

We also cited Salyersville National Bank versus

[A129]

United States and, of course, Teschner versus Commissioner.

THE COURT: Mr. Teschner, before we get into the law maybe we better make sure that I understand the facts, so there is no disagreement as to the facts. Since the defendant didn't put on any evidence I assume that the three of us here can reach agreement as to what, in fact, happened. Let me make sure I understand how this plan worked.

This plan was set up by an agreement between South Bend Tribune and Educo?

MR. TESCHNER: Yes, sir.

THE COURT: And that is Exhibit No. 25. I have taken them out of order here.

The way I read this agreement to work is, what happens is every year or every so often the employer gives Educo a list of eligible children.

MR. TESCHNER: I understand that.

THE COURT: And eligible children are children of key employees or selected employees--

MR. TESCHNER: Certain employees, I think.

THE COURT: Who are either eligible for college or who are going to college or who can or will be attending college in that year.

MR. TESCHNER: Yes, sir.

THE COURT: And that is Exhibit 44.

MR. TESCHNER: Yes, sir.

[A130]

THE COURT: Now, is there anything in the trust agreement that defines how the decision is made as to which children or rather whose children are designated to be eligible for these benefits?

MR. TESCHNER: I don't believe so. I think there is a provision in there which provides that enrollment schedules will be forwarded from time to time to the trustee.

THE COURT: What are enrollment schedules?

MR. TESCHNER: Well, I think there are eight of them. I don't know which exhibits they are, offhand. They are in the--

THE COURT: Do you have a list of exhibits? Do you have a set of exhibits?

MR. PHILPOTT [Counsel For Defendant]: Exhibits 27 through 34.

THE COURT: Now, what do Exhibits 27 through 34 do?

MR. TESCHNER: These are enrollment schedules and what they do is they list certain children of certain employees of South Bend who will be eligible to receive college scholarships, if they decide to go to school and if they qualify and so on.

THE COURT: So these are the lists of employees who have been designated as participating in the plan?

MR. TESCHNER: Children of the employees. I

[A131]

imagine the employees are also listed there, aren't they?

THE COURT: Well, it says employees and children's names. So that it lists W. G. Wheeler, Jr., and then underneath James D. Wheeler, being Duncan Wheeler.

Then, if we skip a couple of lines, R. S. Henderson, who has two children, Sandra Henderson and Susan Henderson,

and Susan Henderson wasn't eligible to go to college until this year, June 1, 1984.

Now, what would have happened if Mr. Henderson had another child a year later?

MR. TESCHNER: Well, I understand he would have had that child listed on an employment schedule also.

THE COURT: So on next year's schedule, enrollment schedule, we then would have R. S. Henderson and instead of having two names there would be three names?

MR. TESCHNER: There would be three, right.

THE COURT: And one of them would be eligibility date 18 years later or thereabouts, when that child would be eligible to go to college?

MR. TESCHNER: Yes.

THE COURT: Now, what happened,

just for my information, in terms of it gets to be June 1 of 1983, and Ms. Susan Henderson is a year away from college and let's say the South Bend Tribune decides, gee, we think we are going to dis-enroll Mr. Henderson and his children under

[A132]

the plan. Is that possible? Is there a contractual agreement that will preclude that?

MR. TESCHNER: Well, I understand in the case of death or disability--

THE COURT: No, no death or disability. Mr. Henderson continues at his salary and position, continues as an employee, there is no diminution in salary, but Schurz Communications decides that he, for whatever reason, is no longer a key employee or its generosity is not as pronounced as it was in the past and dis-enrolls Mr. Henderson from the plan.

MR. TESCHNER: I would say there is no way of accomplishing that. I think the plan has got to be written parallel with the trust agreement itself.

THE COURT: All right. Why don't we do that, so I understand how the mechanics of this works.

The trust agreement is Exhibit No. 25 or 24--

MR. PHILPOTT: Exhibit No. 23, Your Honor.

THE COURT: This is the agreement between the bank and Educo, O.K. Why don't we look at that. O.K., so Exhibit 23, Exhibit 25 and Exhibit 27 and also Exhibit 44, O.K.

So let's say this is now 1983 and Mr. Henderson, who has all along been told you are eligible for the plan, you are enrolled in the plan, is now told or there is an attempt made to disenroll him from the plan, what would

[A133]

preclude that from happening?

MR. TESCHNER: Well, I am certain, Your Honor, it could happen, but unfortunately I didn't bring those particular exhibits with me and I haven't committed them to memory.

THE COURT: What would those exhibits be?

MR. TESCHNER: Once those children are listed as beneficiaries--

THE COURT: You can have mine to look at, if you would like.

MR. TESCHNER: Once the children are listed as beneficiaries -- well, it seems to me Paragraph 4 would be in point--

THE COURT: Paragraph 4 of what?

MR. TESCHNER: Paragraph 4 of the agreement between South Bend and Educo.

THE COURT: This is Exhibit 23 or Exhibit 25?

MR. TESCHNER: Exhibit 25.

THE COURT: What does Paragraph 4 say?

MR. TESCHNER: Paragraph 4 says, "Company shall direct trustee from time to time to pay subject to and in accordance with the plan and each Schedule I the educational expenses as hereinafter defined in II, the uninsured medical expenses as hereinafter defined of the child or children named in said schedule, which shall be incurred

[A134]

while attending any institution or learning, following completion of the twelfth grade, high school graduation or acceptance in such institution prior to completion of the twelfth grade in accordance with any accelerated course of study, whichever event shall occur first." I

would interpret this as clearly meaning that once a child is listed in an enrollment schedule that the child is entitled to benefits, as long as his parent remains an employee of South Bend Tribune. I can see no other way to interpret it.

THE COURT: Well, let's say that South Bend Tribune decides to do the unthinkable. Let's just think our way through the mechanics.

They remove the name of the employee and his children from the following years eligibility schedule, what does the trustee do?

MR. TESCHNER: I believe these eligibility--

THE COURT: And it does not pay, in fact.

MR. TESCHNER: I believe the eligibility schedules are cumulative, aren't they? They don't re-list every child on every eligibility schedule.

THE COURT: I believe they do, in fact. This is 27, 28 whatever. I believe that, in fact, they do.

MR. TESCHNER: They do list all of them.

THE COURT: Here's 28, here's 29, here's 30, here's 31, 32, 33, 34. I wonder if it is all of them. Just

[A135]

looking under Henderson I see Susan and Sandra Henderson as being listed in all of these. So what happens if one year a name is deleted?

MR. TESCHNER: Well, I would say also Paragraph 7 would be in point. "If any employee whose child or children are covered by the plan shall cease to be employed by the employer it shall be the duty of the employer to so notify the company."

The negative implication of this,

to my way of thinking, is that ceasing to be employed by the employer is the only reason to remove a child or children from the plan.

THE COURT: I understand, but let's say that they do it anyway. Who would sue whom, where and for what?

MR. TESCHNER: Well, I would assume Educo would sue South Bend Tribune for--

THE COURT: Educo would bring a lawsuit against South Bend Tribune for what?

MR. TESCHNER: Well, for breach of the total trust agreement, in effect. By scheduling these children in enrollment schedules it seems to me--

THE COURT: How did Educo know, it may be that Mr. Henderson has been fired or it may be that Mr. Henderson has gone to work for a rival newspaper or it may be that Mr. Henderson has voluntarily withdrawn himself from the plan or any number of things, how does Educo know that his

absence from the list, maybe Mr. Henderson's two children were killed in an unfortunate accident, how does Educo know whether the withdrawal of a particular employee from the list is rightful or wrongful?

MR. TESCHNER: I really can't answer, Your Honor, but I do know this, that the amounts paid into the trust for the benefit of the children who are no longer listed simply cannot be returned to the Company.

THE COURT: I am not so much concerned about what happens once you start paying out on account of a child. I am interested in the awkward periods between the point in time where the employee is told you're O.K., you are on board, and the point in time when money is actually paid by the employer with respect to that obligation. As I understood Mr. Wheeler

to testify, you can make a decision in year one that a particular employee, actually the particular employees enrolled in the plan, so that his children become eligible to participate, but if the children are not of college age there are no monetary consequences in that year. The monetary consequences take place whenever the first child of that employee becomes eligible for college, age for entering into college and, in fact, takes advantage of the opportunity, is that correct? Is that a correct interpretation?

MR. TESCHNER: I believe that is a correct inter-

[A137]

pretation.

THE COURT: So the company doesn't pay out a penny until the child of an eligible employee, an eligible employee

being one that is enrolled in the plan, actually goes to college?

MR. TESCHNER: Well, the company pays into trust every year. The funds are in trust for the children and you have the law of trust which would then be applicable, I would think.

THE COURT: When does -- let me have those exhibits again.

All right, let's go back to -- well, I have enrollment schedule No. 2. You must have -- which is Exhibit No. 28. You have enrollment schedule No. 1, which is Exhibit 27.

We see here that Mr. Henderson, I assume it is Mr. Henderson, R. S. Henderson, that R. S. Henderson has two children. One of them is eligible for payment starting June 1, 1979, and one of them, another one is eligible on June 1, 1984. Enrollment schedule No. 2 was prepared in 1976, so both of these are future events.

Were any monies paid by South Bend Tribune in 1976 with respect to either Ms. Sandra Henderson on Ms. Susan Henderson?

MR. TESCHNER: I don't believe so, Your Honor.

[A138]

I think -- Mr. Whiteside is an actuary and an accountant and I assume that he drafted this payment amount annually in order to provide funding for all the future costs of the children attending college.

[A139]

THE COURT: Well, let's abstract a little bit. Let's assume that the Henderson children were the only children in the plan, all right?

MR. TESCHNER: O.K.

THE COURT: And the plan was in effect in 1976 or 1975, both years.

Would South Bend Tribune have paid anything to EDUCO in either 1975 or 1976?

MR. TESCHNER: Well, again, Your Honor, I can't answer absolutely. It seems to me this should be actuarily sound as a plan.

THE COURT: Well, Mr. Wheeler testified that payments were made in the year--payments were made to EDUCO for the first time in the year a child became eligible to receive pay ment out of the fund. So, if I understood his testimony, what he said was if Sandra Henderson became eligible on June 1, 1979, the first time that South Bend Tribune would make a payment to EDUCO with respect to her would be on June 1, 1979, and that if, in fact, Sandra Henderson decided not to go to college they would just not make a payment. They would check with the employee and if the employee said, oh, Sandra decided to go join a hippie commune, the company would never pay. Now, that is how I understood his testimony. That

is why I after--

MR. TESCHNER (interrupting): I guess I missed that. I would think that Exhibit No. 44 which lists the used and

[A140]

unused amounts of scholarships is indicative that if the person arrives at college age and doesn't use all the funds available, then they go into the unused column.

THE COURT: No, no. I am not talking about people who come of college age and use a portion of the funds, but don't use up all of them. The people I am concerned about are those who are not yet of college age. Let's say, they are a child of 16 years old who dies at the age of 17. He is an eligible employer and he has two children, one of them 16 and one of them 14. One of the children dies before reaching college age. The question I thought

I had asked Mr. Wheeler, and I thought the question taht he had answered, was what payments are made with respect to that child. I thought his answer to me was they don't pay anything out until the year that the child is actually enrolled in college and if the child does not enroll in college they don't pay anything out on behalf of the employee. Now, again, the reason why I wanted to talk about the facts before I talked about the law is that is not how I felt things worked and it seems to me we ought to be able to get into at least the way the arrangement worked before we start getting into some legal area.

MR. TESCHNER: Well, I am sorry, I guess I missed that testimony, Your Honor. It is unfortunate that I didn't ask Mr. Whiteside because he is the one that could have

[A141]

answered it immediately. I just always assumed it was on an actuarial basis.

THE WITNESS: I have a feeling it was on an actuarial basis too, but Mr. Wheeler, whose is the only testimony we have on this point on the record, seem to think the opposite. Let's take a break and maybe we can get the reporter to play it back, that portion of Mr. Wheeler's testimony and we can sit here and analyze it. I am not trying to invent things out of thin air, but that is what trials are about. I need to know how the thing actually worked. If we don't know for a fact when payments were made, it seems to me until I either figure out what happened, before I make a finding on the basis of the record as to what happened, I feel there is no use talking about the law. If you think that this plan works on the basis of

actuarial payments made with respect to children of employees as soon as the impression that payments are not made until a child actually becomes eligible to draw out monies from the fund, you are going to be arguing one thing and I am going to be ruling on the basis of something else.

Maybe Mr. Philpott has something to say on that subject.

MR. PHILPOTT: Your Honor, I can understand your question. It all goes to the statutory symmetry of the Con-

[A142]

gressional plan. You have to take into consideration Section 61, Section 83, Section 162 and--

THE COURT (interrupting): I am not concerned with tax consequences right now. I basically need to know when as a matter of fact were payments made.

MR. PHILPOTT: Are you talking about payments to the children or payments to the trust?

THE COURT: Payments to the trust. I want to concentrate on--

MR. PHILPOTT (interrupting): It happened both ways, Your Honor. In Greensboro--

THE COURT (interrupting): I don't want to talk about Greensboro. I want to talk about this case.

MR. PHILPOTT: I understood Mr. Wheeler to say that they can make prospective payments in Year 1 for Year 4 of the child, but the child wouldn't be eligible in Year 4, but in the case we have now of Wheeler and McLaughlin, it is all very neat. The deductions were taken in 1975 and the government is claiming it is income in 1974, 1975, 1976. In Greensboro we said--

THE COURT (interrupting): Well, I understand, and this may be the limiting case in the way and maybe I will have to decide this simply on the basis of this particular case, but I would like to know how this plan, in fact, worked.

MR. PHILPOTT: If I may go to, if you remember

[A143]

the testimony of the first couple of witnesses, well, all witnesses said it was for key employees and Mr. Wheeler and Mr. Whiteside were asked can you amend the enrollment schedule and they said, oh, yes, at any time at the discretion of the board directors. The company wanted--anything they wanted to do they can. They can do the unthinkable and cut out somebody thinking he is going to get these benefits. Now, there is nothing in the plan that I see as to

whether he had the legal right to go against them. He might have an implied contract right. What if a child does not choose to go to college? The point is when the payments are made of the expenses the government says you can get a deduction as the employer and the parent, you have got to pay when the payment of the expenses occur.

Now, we lost the deduction question--not before Judge Willi--we lost the deduction question before the federal circuit, but on the income question the federal circuit said we are not going to reach it and that footnote that Judge Kashiwa put in there, and I am glad he put in that Footnote No. 3, but in Armantrout, the Seventh Circuit--

THE COURT (interrupting): I really don't want to talk about the tax law.

MR. PHILPOTT: I am trying to answer your specific question on the facts that I may be able to help you out with.

THE COURT: Well, I--

[A144]

MR. PHILPOTT (interrupting): Both can happen, though. Say Mr. Wheeler only had one child and they decide they want to keep Mr. Wheeler, he is a good employee, and they--

THE COURT (interrupting): Let's take Exhibit No. 28. Do you have Exhibit No. 28 there?

MR. PHILPOTT: I believe not.

THE COURT: 27?

We can take my Exhibit No. 28. If you have 27, 28, 29, they are all the same.

MR. PHILPOTT: Will you tell me what it is?

THE COURT: An enrollment schedule No. 2.

MR. PHILPOTT: O.K., I have it.

THE COURT: Let's go down to R.S. Henderson.

MR. PHILPOTT: Yes.

THE COURT: O.K. This is 1976. His children don't become eligible for enrollment in college until at the earliest 1979. What I would like to know is did the plan in 1976 or rather did South Bend or Schurz in 1976 pay anything to EDUCO in effect to Sandra Henderson or Susan Henderson?

MR. PHILPOTT: On the basis of what I know about the case, I would say no. What if they had?

THE COURT: I don't want to talk about what would happen if they had. I would like to figure out a simple fact

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about this plan.

Mr. Teschner, what is your impression as to what happened? In 1976 was anything paid into the plan with respect to Sandra Henderson or Susan Henderson?

MR. TESCHNER: I don't believe so.

THE COURT: The first payment for Sandra would be made in 1979 provided that Sandra Henderson decided to go to college?

MR. TESCHNER: My understanding of this particular plan, and most EDUCO plans, is that you have got to take into account the future interest that will be payable on the funds and the future expenses which are chargeable against the fund and you can't simply look at this and make that determination of whether it is actuarial or not. I can't imagine a plan which isn't.

THE COURT: Well, it said payment period at the top. It says payment period 1977 $35,542. What I would like to know is if any portion of that $35,542 for 1977 was paid on the account of Susan Henderson or Sandra Henderson. Let us say that Mr. Henderson had not been a member of this plan in 1975, 1976 or 1977. Would the

payment for that year have been any different because of his participation or lack thereof? You see, he didn't have any children eligible to go to college that year. It is a simple question.

MR. TESCHNER: I know it is a simple question and

[A146]

I am sorry I didn't ask Mr. Whiteside because he could have answered it. Actually he lives in Lake Forest and if you wanted to take a break I could call him or you could call him.

THE COURT: Well, my law clerk just said to me that if you look at the 1976, going back to Exhibit No. 28, in 1976 there were 16 children eligible to draw payments times $2,000 is $32,000. The payment actually made was $31,022, which, I presume, starts with a base exposure of $32,000 during the year, this counts

for interest earned in the year and adds administration expenses for the year. I assume that is how it is derived.

MR. PHILPOTT: That sounds reasonable, but we do not have the trust, the amount that is in the trust at the beginning here. They may have in the trust amounts that lapsed from a child that died. We had evidence that some children didn't use all that was available.

THE COURT: What about 1975, which was the first period, what did that provide?

MR. PHILPOTT: Well, Your Honor, 1975 is our first tax year, but this plan goes back to 1972, 1973, 1974.

THE COURT: Oh, it does?

MR. PHILPOTT: Yes.

THE COURT: What happened in 1972, 1973 and 1974?

MR. PHILPOTT: It is prejudicial, if you want me

[A147]

to tell you.

THE COURT: I want you to tell me, but stand back a little bit so you are closer to the microphone.

MR. PHILPOTT: The parents did include these amounts in their income and then they would try not to. That is what happened.

THE COURT: It doesn't matter either. I have seen the Commissioner change his mind more often than that.

MR. PHILPOTT: That's right.

THE COURT: O.K., let's get back to the question I had originally asked you, Mr. Teschner. What would happen if the company got unhappy with Mr. Henderson for some reason and decided to pull him from the plan. The board of directors meets and says, oh, Henderson is not as valuable to us as he used to be and I

know that next year he has got a daughter that wants to go to a very expensive college and we just don't feel like paying that money. What would happen? What would be the remedy? Who would be able to challenge that kind of a situation?

MR. TESCHNER: Well, the guardian could for the children themselves. They are listed as beneficiaries under the trust. It seems to me they have got a right to expect college scholarships when they arrive of age.

THE COURT: So what you are saying is that it would

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be a lawsuit by the children as beneficiaries of the agreement between EDUCO and South Bend Tribune?

MR. TESCHNER: Yes. I would so advise them.

THE COURT: Then the question would be whether or not the trust agreement, whether the actual agreement, in fact, provides vesting, in effect, of the rights to be included in the plan?

MR. TESCHNER: I think that would be a complex question on the law of trusts, but it seems to me a good case could be made for the children.

THE COURT: All right. O.K. I think I understand how the arrangements work.

Why isn't this case just like Basye?

MR. TESCHNER: Well, Basye, as I said this morning, is a partnership taxation case. The law of partnership income taxation is unto itself, whereas First Security Bank of Utah and Greensboro were entities, corporate entities, Basye was strictly a medical partnership. It seems to me there is no doubt whatever that the amounts put into this trust for

the various partners eventually would go to the partners. The partners tried to argue that because they had no present right to receive the amount that, therefore, they could not be taxed.

THE COURT: The only thing that was clear at all was a good portion of these payments would go to somebody

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else than the partners. They were partner physicians and non-partner physicians and the retirement plan was for the benefit of the partners so that if anything was clear it was that the partners would not get everything that was contributed by Kaiser into the retirement plan.

MR. TESCHNER: Well, that may be so, but partnerships are treated as combinations of aggregates and entities and they must file a partnership tax return. The individual partners must take into account

their distributive share under that plan.

THE COURT: I think that is all true, but isn't that Footnote 8 where the court says it seems odd we should still be discussing such things in 1982? How was it a partnership case? Was this a situation where basically the partners got together and agreed to split off some of their income by having it diverted, first of all, to a plan that benefited them, then to a plan that benefited them in the sense of it made it--it was a benefit to the employees and, therefore, made it more likely they would be able to hire and maintain employees who were qualified. Isn't that all that happened in Basye?

MR. TESCHNER: I don't know if Basye involved the employee physicians at all. I do know it involved the partner physicians.

[A150]

THE COURT: The question is whether the partnership received--

MR. TESCHNER (interrupting): Whether the partners received income, that's right.

THE COURT: That's right, by the payment of Kaiser to the retirement plan of the partnership.

MR. TESCHNER: That's right.

THE COURT: Now, the payments were in respect to the partners' retirement and the employees' retirement.

MR. TESCHNER: But I believe the only question related to the partners.

THE COURT: Yes, but it was for the full amount paid to the partnership retirement plan.

MR. TESCHNER: Well, that is right because apparently the employees had no vested right to receive. Their money had to be accounted for through

partnership distributions. Reg. Sec. 1.702-1 says income and credits of partner, general rule, each partner is required to take into account separately in his return his distributive share whether or not distributed of each class or item of partnership in come, gain, loss, deduction or credit, described in Subparagraphs 1 through 9 of this paragraph. Mr. Merten in his work on partnerships says, "Partnerships have a peculiar status under the income tax laws and are not taxable as such. Persons carrying on business as partners

[A151]

are liable for tax only in their separate or individual capacities. The partnership, therefore, files no taxable return"--

THE COURT (interrupting): Let me simplify the Basye case for you. Let's

assume there wasn't a partnership. Assume it was one doctor. Just one guy. He had so many employee doctors. O.K. He entered into this plan with Kaiser and he would provide services for his clinics and Kaiser made payments to him in compensation for these sources, plus it contributed to his retirement plan, a retirement plan which he had set up for himself and all of his employees. Would you see the result in Basye any different if it was just one guy as opposed to more?

MR. TESCHNER: No. I think he would have been taxable.

THE COURT: All right. So we then can do away with partnership taxation in--

MR. TESCHNER (interrupting): Certainly, because what you are considering is income. However, in this case we

don't have that question. This case involves a question of whether employee parents who never could have done anything to get the wherewithall to pay the tax must pay income tax not measured by the benefits which they enjoyed in seeing their kids get scholarships, but measured by the full amount of the scholarships. It seems to me that this case is con-

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trolled by First Security Bank of Utah and not by Basye.

THE COURT: How is it controlled by First Security Bank of Utah?

MR. TESCHNER: Well, because First Security Bank of Utah specifically says, "We know of no decision of this court when any person has been found to have taxable income which he did not receive

and which he was prohibited from receiving. In cases dealing with the concept of income, it has been assumed that the person to whom the income was attributed could have received it. The underlying assumption always has been that in order to be taxed for income, the taxpayer must have complete dominion over it. The income that is subject to a man's unfettered command, and that he is free to enjoy at his option, may be taxed to him as his income whether he sees fit to enjoy it or not. It is, of course, well established that income assigned before it is received is nonetheless taxable to a assignor. The assignment of income doctrine assumes that the income would have been received by the taxpayer had he not arranged for it to be paid to another." Well, I think the testimony was undisputed that there was nothing these employee parents could have done to have received any income.

It seems to me that the First Security Bank of Utah--

THE COURT (interrupting): The First Security Bank of Utah, though, dealt with illegal ineligibility, as I

[A153]

understand it. The entity there in question, the bank, simply was not eligible to sell insurance, act as an insurance agent. There was no legal ineligibility from these employees receiving the money. In fact, the employer could give somebody a raise or could enroll them in the program if he wanted to make people happy. Were there any employees who were in the program who did not have children?

MR. TESCHNER: Who did not have children?

THE COURT: Yes, didn't have any children.

MR. TESCHNER: I believe not.

THE COURT: The only reason to enroll somebody in it is if the person has children and they would likely see it as a benefit. Were there any employees that said no, don't enroll me in this thing? Do you think there were? Would you guess?

MR. TESCHNER: I think in some of these cases we cited they say that some parents regarded it as better for their children to work their way through college than to get scholarships. The children are the ones who benefited here, not the parents. The parents merely happened to work.

THE COURT: That is splitting hairs, though, pretty far, isn't it?

MR. TESCHNER: I don't believe so. I think there are two cases we cited in our second memorandum, Bank of Coushatta vs. the United States and Bank of Winnfield and Trust

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Company vs. the United States, one decided in 1981 and the other in 1982.

THE COURT: Why don't you point me to that portion of the memorandum. I don't actually recall seeing it. This is your memorandum dated July 23, filed July 23. What were those two cases again?

MR. TESCHNER: The Bank of Coushatta vs. the United States, Fifth Circuit, 1981 case, F.2d 75, 77. Bank of Winnfield and Trust Company vs. the United States, Western District of Louisiana 1982, 540 F.Supp. 219, 222. Each of these cases rejected out of hand the argument that First Security Bank was based only on a legal disability.

THE COURT: Why don't you tell me about these cases, tell me what they involve.

MR. TESCHNER: Well--

THE COURT (interrupting): Can First Secuirty Bank of Utah survive Basye unless it deals with legal disability? Explain to me how--

MR. TESCHNER (interrupting): Well, here at the two cases cited at Pages 46 and 47 and 48 of our supplemental memorandum.

THE COURT: O.K. Let me look at that.

(Pause.)

[A155]

THE COURT: Let's use some common sense. We are dealing with employees, mostly middleclass or upper middleclass, who have children that likely will go to college and who, at least as far as these two Plaintiffs are concerned, testified that they would have supported them or intended to support them. How can a court rule that combine those

benefits which would accrue indirectly to a parent by virtue of the benefit he gets by seeing children in college and directly by the fact that although parents do not have a legal obligation they nevertheless feel a moral obligation to make the payment. How can the court rule that, under those circumstances, that payment is not income to the parent?

MR. TESCHNER: Your Honor, I think now we are getting into the area of fringe benefits. As you probably know, fringe benefits--Congress enacted a statute which is still effective. It said that the Commissioner of the Internal Revenue Service in effect you get out of the fringe benefits area because we think Congress has the right to make these determinations.

THE COURT: What statute is this?

MR. TESCHNER: This is PL 96167, 93 Stat 1275, December 29, 1979.

THE COURT: What does it say? Is that codified?

MR. TESCHNER: It is--I don't believe it is--it is not codified in the Internal Revenue Code.

[A156]

THE COURT: Do you have a copy of that?

MR. TESCHNER: Yes.

THE COURT: I would like to examine it, then, when you get through reading it.

MR. TESCHNER: I have an extra copy of the original. I don't have extra copies of the Subsequent one. Do you want the original?

THE COURT: O.K. I will settle for whatever I can get.

(Pause.)

MR. TESCHNER: The legislative history is exhaustive and notes that the

question of fringe benefits is a very difficult one to tax somebody on the full value of what the employer spends for something simply because you assume that his benefit is equal to the amount expended isn't necessarily true. Congress for a period of several years has studied this whole problem of fringe benefits. It seems to me that I would say the educational benefit plan is not really a fringe benefit because it is not a monetary equivalent.

THE COURT: Both of these Plaintiffs said that they would have paid, they would have sent their children anyway; even with the contributions made from this plan they wound up having to take money of their own of some substantial amount. How can you really do anything but subtract what was

[A157]

paid in this plan from the total amount

and if they wound up paying something in addition, then you come to the conclusion that they have not been paid for this plan and it has come out of the pocket of Mr. Wheeler and Mr. McLaughlin.

MR. TESCHNER: I would not equate a scholarship received by my child with the full value to the child of the scholarship to me. It seems to me you can get scholarships from all sorts of places.

THE COURT: Let's just talk about factual. Let's say that your child is enrolled in college and on her way to her first class found a $2,000 bill on the ground and latches onto it and says, "Dad, instead of paying my tuition and paying my room and board for the next year, you don't need to bother. I just found this new $2,000 bill and I am going to pay for it myself." Now, assuming you would have paid the tuition and assuming you would have paid

room and board, are'nt you $2,000 richer at that point?

MR. TESCHNER: Metaphysical argument could be made, but I don't think so. I wouldn't regard myself as $2,000 poorer if I had to pay for her college. I don't think I am $2,000 richer because she has simply found some money.

THE COURT: O.K., so you are $2,000 less poor than you would have been had she found the money?

MR. TESCHNER: Yes.

THE COURT: Had she found the money and decided to

[A158]

spend it on the boys instead of college. Let's say she found a $2,000 bill that says "can be spent only on tuition and such things." Isn't your net wealth,

assuming you were going to pay for those things yourself, wouldn't your net wealth increase by that amount?

MR. TESCHNER: The concept of the net amount is an economic concept. We are dealing with the Internal Revenue Code here, which is not based on an economic concept. It is based upon tax codes.

THE COURT: It seems to me for something to be taxable that more things have to occur than a net increase in wealth. Doesn't a net increase in wealth, isn't that the first step?

MR. TESCHNER: I would say it is the second step.

THE COURT: What is the first step?

MR. TESCHNER: I would say the first step is based upon the tree fruit analogy of Justice Holmes where he said there is the tree that produces the income, then there is the fruit which is the income

itself. These two things have to occur before somebody can be taxable. You can't separate the tree from the fruit and simply tax one person or the other. Now, assuming in this case these employee parents rendered services, and they certainly did, this would be equated with the tree of that analogy, but they didn't receive income and they never could have received income

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notwithstanding their will in the matter.

THE COURT: Let's examine that for a minute. What do you mean they couldn't have received income and they didn't receive income? What makes you say that?

MR. TESCHNER: I think if they received income it was just economic income. It wasn't income as defined in the Constitution and in the Internal Revenue Code.

THE COURT: Are you saying the decision to include the particular employee's children in the educational plan was because the board thought they looked cute?

MR. TESCHNER: No.

THE COURT: Was it any reason other than the fact that the employer appreciated the employee's services? He felt them to be important and wished them to continue?

MR. TESCHNER: I think that is true, but they didn't have a right to receive and they never could have done anything to have received.

THE COURT: Isn't it exactly what the Supreme Court said in Basye--

(Pause.)

THE COURT: This is at Page 451. The court's reasoning seems to be the partnership can be found to have received in-

come it must be proved that Permanente agrees or accepts less compensation from Kaiser in exchange for the retirement fund payments. They have got these people

[A160]

working for a company for 31 years, they get occasional raises, benefits, inducements, pats on the shoulder, letter of commendation and lord knows what. Do we really have to sit here and guess as to how it is they got themselves this particular benefit package?

MR. TESCHNER: I think so. I think that is the law. If I could read from Page 26 of our first memorandum.

THE COURT: O.K.

MR. TESCHNER: "Another example of invidious discrimination in the area of

job-related benefits and enjoyments is the treatment which Defendant accords members of Congress. One of the Defendant's theories here is that the individual Plaintiffs should be taxed because they entered into or continued employment with South Bend Tribune knowing full well that amounts would be spent by their employer from which they would receive certain benefits and enjoyments. The Respondent accords far different treatment to members of Congress who receive benefits and enjoyments which they would not receive but for the fact they are employed by the government." This is Rev. Rul. 77-323.

THE COURT: This is your equal protection argument?

MR. TESCHNER: 1977-2 CB#18, yes.

THE COURT: I understand that you have a Constitutional argument, but just for the ease of my understanding why don't

we treat the Constitutional argument

[A161]

separately. What you are saying is if that is what the Tax Code provides the Tax Code is unconstitutional? Isn't that what you are saying?

MR. TESCHNER: Yes, this is part of the argument, equal protection. It is also just plain fairness.

THE COURT: Is it fair that the people who earn more pay more taxes?

MR. TESCHNER: Yes, I think it is fair.

THE COURT: I don't.

MR. TESCHNER: I don't earn that much, though.

THE COURT: I don't think it is fair, the tax code is not fair. It doesn't matter whether you or I think

it is fair. Is it fair that the tax code is only graduated as much as it is? Some people think it is unfair. It ought to be graduated even more. Taxes don't have to be fair. Fairness is nice, but it is not a requirement of the Constitution. Certainly when it comes to taxes it is not a requirement that it be fair.

MR. TESCHNER: Well, there are other cases, which I didn't cite, on equal protection and on the Constitution as applied to tax law and it does apply to tax law.

THE COURT: Well, we are talking about federal tax cases.

MR. TESCHNER: Federal tax cases, yes, sir.

THE COURT: What were those situations? Now, I

[A162]

understand all those cases involving sexual discrimination and tax cases are different in a way, but discrimination on the basis of wealth and discrimination on the basis of the type of employment you have, is it fair that you get to deduct your mortgage payments if you buy a house, but you don't get a deduction for payment of your rent? I don't think that is fair.

MR. TESCHNER: I am not saying the Internal Revenue Code is fair.

THE COURT: It just happens to be people who are wealthy enough to make the downpayment can get a tax break. I think if you and I and Mr. Philpott would go through the Tax Code and take out those things that are unfair, we would have a much shorter code, but let's talk about the heart of this case and that is the nature of the plan. It is a plan that was established by the employer for the benefit of its employees

and their children.

THE COURT: Yes.

MR. TESCHNER: I would say you can't equate the scholarship amounts with the benefit to the employees, whatever they might be, they are metaphysical benefits.

THE COURT: As a matter of fact, in this case it seems to have been a one-to-one correspondence because both

[A163]

Mr. McLaughlin and Mr. Wheeler said they had to pay additional amounts.

MR. TESCHNER: I don't think Mr. Wheeler said that. He said that his child had worked and he had other sources of income and he might contribute to it.

THE COURT: The child worked, as I understand it, and the payments were made, and Mr. Wheeler said he also made payments on top of that. No? Didn't he say that?

MR. TESCHNER: I would have to read the record, Your Honor.

THE COURT: I think that is what he said. Let me check my notes.

MR. TESCHNER: Mr. Philpott was trying to get him to testify that if the Educo scholarship had not been received they would have paid these amounts.

THE COURT: He said he did contribute money in those years.

MR. TESCHNER: He didn't testify how much money.

THE COURT: No, but he contributed dollars. There was a call on his pocketbook to make further contributions. Doesn't it stand to reason that if amounts had been paid by EDUCO that Mr. Wheeler would have paid the full differential plus what he paid anyway?

MR. TESCHNER: I don't know. That is an iffy question.

[A164]

THE COURT: Let me ask you this. Why should I not infer exactly that? Given that courts are here to give evidence and to---

MR. TESCHNER (interrupting): I don't think it is relevant what they would have done. I think it is relevant that they could have done nothing to have received these scholarships and they couldn't have procured the wherewithall to pay the tax. It seems to me that through a long series of Supreme Court cases that this is clearly the law.

THE COURT; You don't dispute that if Mr. Wheeler had had a legal obligation to pay that tiotion that this would be income to him, do you?

MR. TESCHNER: If he had a legal obligation, no, I think that is the Old

Colony Trust case and the Hansen decision.

THE COURT: So he could have kicked Duncan into the street and said you work your way through college and I don't have to pay anything at all?

MR. TESCHNER: I think we don't disagree with either of these cases. The Old Colony Trust case held that if an employer--an employee realized taxable income when his employer pays his income tax liability. The Hansen case held that automobile dealers paid taxes immediately upon amounts put into trust funds for their benefit by finance

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companies. That case was based on the theory there were only one of two things that could have happened to that money. It would either be paid to the auto dealers directly or it would be paid

to discharge their legal obligations. I don't disagree with either of those cases. I think they are fundamental. If I were to pay your income taxes, you would have to pay taxes on that.

THE COURT: Let's get back to the metaphysics, then. You state that you can't have, you cannot have an economic benefit unless you have a legal obligation.

THE COURT: Let's say that the employer needs to pay rent on a plush downtown apartment. It turns out that Mr. Wheeler owned a house. He has no obligation to pay rent anywhere, but given that the employer pays, is paying for this plush downtown apartment. Anyway, he sells the house and moves himself and his family into this plush downtown apartment. He has no obligation to pay rent. Does that render it any less compensation?

MR. TESCHNER: Oh, I think not. There--well, this is merely a fringe benefit, again, Your Honor.

THE COURT: How about food? Let's say that Mr.

[A166]

Wheeler--does Mr. Wheeler have an obligation to feed himself? Let's say that the employer opens up a charge account at Safeway and tells the employee, I know you have an obligation to eat, but I want you to be hearty. I like hearty, chubby people around me, not the lean types. I want you to feel free to go in there and charge to your heart's content any food you want to and the company will pick up the tab.

MR. TESCHNER: Well, when he charges from the start he owes that money

so he has a legal obligation, but you do get into this area of fringe benefits with some of these.

THE COURT: So it makes a difference as to whether the company opens a charge account or whether they say no, no, you take the treasurer with you and he will stand there at the cash register and he will pay in cash?

MR. TESCHNER: No, I don't think that makes a difference.

THE COURT: Well, what are we talking about?

MR. TESCHNER: We are talking about economics rather than law, specifically tax law.

THE COURT: All right. You think of the hypothetical, you think of the example. No obligation to pay and yet something which people want, people need, people feel comfortable in. Can the

people just pick up any old thing and pay for the employee's benefit? Like clothes?

[A167]

Vacations? What about a vacation? You can work 52 weeks a year, but the employer says, oh, no, he will pay for you to go to Columbia for two weeks and you and your wife be pampered at Club Med.

MR. TESCHNER: I agree that these are all fringe benefits to employees because they have a monetary value. One of the things Congress is studying is how to determine the monetary value of fringe benefits, whether you should simply look at the amount paid by the employer and say that's the fringe benefit or--

THE COURT (interrupting): So you would say this is prohibited by Public Law 95-427?

MR. TESCHNER: Which has been continued every since.

THE COURT: What happens these days when an employer sends an employee off for a plush vacation in the Carribean?

MR. TESCHNER: There is a whole series of cases on that. The Rudolph case and several other cases. They held it was not taxed because this was a fringe benefit related to his employment for the primary welfare of the employer.

THE COURT: For the primary welfare of the employer?

MR. TESCHNER: The employer.

[A168]

THE COURT: O.K.

MR. TESCHNER: The employer paid for the educational benefits here and that was done for the primary benefit of the empoyer. I don't think it is for the primary benefit of the parent. Maybe it is a secondary benefit to the kids and a tertiary benefit to the parents.

THE COURT: Of course any time someone spends money it must be that the expenditures is more advantageous than keeping the money. Nobody is going to dispute that the employer benefits. The employer benefits when he pays a salary too. He must feel that the employee is worth more than the salary which is he being paid.

MR. TESCHNER: The law is developed in the term of primary benefits. The primary benefit is to the employer, the incidental benefits to the employees.

THE COURT: Let's talk about the Greensboro case for a minute. I am not sure I understand what happened.

MR. TESCHNER: I think the main thing is because it entered this whole field of deferred compensation.

THE COURT: I think we have a deferred compensation case here.

MR. TESCHNER: I think rather simply

if you don't have compensation on one side you can't have compensation on the other side. I know that case concerned deductions instead of income.

[A169]

THE COURT: As I read the case, the question was whether this was under Section 404 or Under Section 162.

MR. TESCHNER: Right, and the 404 possibility was because of the ruling by the Internal Revenue Service, the Commissioner, in, I think it was Rev.Rul. 75-448. I think this is where this case will be going certainly on appeal. I think the language at Pages 22 and 23 is certainly right on point.

THE COURT: 22 and 23 of what?

MR. TESCHNER: Of our original memorandum, Plaintiffs' memorandum of fact and law, dated 9 May.

THE COURT: O.K. 22 and 23.

This is starting at Page 1203.

MR. TESCHNER: Of the Greensboro case?

THE COURT: Yes, 698 Fed.2d at 1203.

MR. TESCHNER: 698 Fed.2d at 1203, right.

THE COURT: What is helpful about that language?

MR. TESCHNER: Well, the government has not made any allegations that this plan is a sham. We find it provides what it purports to provide, i.e., educational benefits for employee's children. The government has not alleged the appellant has retained an inordinate amount of control over the trust fund such that the result is an illusory benefit. The plan, unlike that involved in Citrus, is independently administered by a trustee whom the appellant does not

[A170]

control. The appellant retains no day-to-day control over the trust fund. The trust monies may never revert to or inure to the benefit of the corporation, thus the corporation has actually spent the money it wishes to deduct. The purpose of the plan, education of the employee's children, is clearly a purpose concerned with the well-being of the employees and their families. The benefits provided the employees are not based in any way upon the company's earnings, but instead are set. The benefits are available to all employees, which is a little different from our situation, not just owners or key employees.

THE COURT: Well, it is a whole lot different.

MR. TESCHNER: Well.

THE COURT: From our situation,

MR. TESCHNER: I think our plan is not for the benefit of shareholders as in Grant Jacoby and it is not the situation in Armantrout where the employees could have bargained to receive additional compensation. I think the employees who are selected are broadly based enough. The shareholdings were only 2 per cent at the most.

THE COURT: I am not sure what the significance is. The plan--this is not a dividend. It is compensation for--

MR. TESCHNER (interrupting): In the Grant Jacoby case the government did argue in part that this was a dividend and the court rejected that argument.

[A171]

THE COURT: But being an owner or being a shareholder in a corporation

seems to me it can only be relevant to determining whether or not something is a dividend, not whether it is compensation for services.

MR. TESCHNER: Well, they argued both. They said it was compensation because the five shareholders who controlled the--

THE COURT (interrupting): Well, assuming this case is just like Greensboro--there is a difference and I don't know how significant a difference--but assume that it is. Greensboro goes to the question of whether or not--actually it didn't even go to the question of when the employee can deduct. What did Greensboro have to say on the question, if anything, of whether or not employees receiving, whose children of those employees--

MR. TESCHNER (interrupting): It doesn't have anything to do with it.

These are two different sections. Section 61 is involved here, Section 162 is involved there.

THE COURT: I understand, but you said this is going to go on appeal to the federal circuit and the question is what--

MR. TESCHNER (interrupting): I think they left that question unanswered specifically. I think Mr. Philpott said they would go--

[A172]

THE COURT (interrupting): You said Armantrout, that this was not like Armantrout because we are not concerned with whether or not this is income to the employees, it only answers the question of when can the employer deduct. If I understand this case correctly, this case doesn't matter, the deduction happens to occur in the same year that the payments were actually made to the children.

MR. TESCHNER: I think it matters in the sense that they were defining the term "deferred compensation." As Arthur Young's letters and in some of the Commissioner's early rulings indicated, they held these were deductible under Section 162. Then the government developed this theory of deferred compensation, said because of the deferred compensation plan now the employer doesn't get a deduction immediately in the year in which they make the contributions, but they have got to wait until the kids go to school. So I think it is relevant. Certainly not directly in point, but they have got to so be it. That is the nature of the law.

THE COURT: You see I would expect Mr. Philpott to argue that Greensboro helped him.

MR. TESCHNER: Well, he can argue that if he wants.

THE COURT: I mean isn't the argument they said yes, you deduct it as an ordinary and necessary business expense in the year when paid would make it more likely that

[A173]

this is, in fact, compensation just like a salary? Salaries are an ordinary and necessary business expense.

MR. TESCHNER: If it is not deferred compensation, I assume it is not compensation.

THE COURT: Maybe the court would have found that this was compensation in the year when paid.

MR. TESCHNER: Maybe, but I have difficulty with seeing that the parent, employee parent, had any income of any type, compensation or otherwise. So that is basically our position.

THE COURT: How do you distinguish this case from Armantrout?

MR. TESCHNER: Well, Armantrout, Judge Goffe made the statement that the employees could have bargained to have received additional compensation in lieu of their children's participation in the plan and from that reasoning his next step was therefore since they had the power to have received these amounts this was merely an anticipatory assignment of income, with the spirit of Lucas v. Earl and all the others.

THE COURT: Do you recall where he said that?

MR. TESCHNER: Pardon?

THE COURT: Do you recall where in his opinion he said that?

MR. TESCHNER: I didn't bring that opinion with me.

[A174]

THE COURT: I feel, as best I can tell, that the appellate court was--and this is at Page 212, 570 Fed. 2d--it can not be assumed that petitioners were not without control of the manner in which they were compensated. Actually I should read the whole sentence. Second, from an employee perspective, because the EDUCO program was designed to attract and satisfy key employees, because arm's length negotiations existed between the parties, distinguishing Teschner, and because it is admitted that employees all wanted it, Paragraph 34, it cannot be assumed that petitioners were not without control of the manner in which they were compensated.

MR. TESCHNER: I think the record is clear here that the employee parents were without control.

THE COURT: Citing Basye. As a tax

court judge found, there was no evidence to indicate that the Petitioners were unable to bargain with Hamlin about the terms of their employment of compensation. As Basye held, "It is immaterial if the payments were never received by the taxpayers, for the principle of income taxation is that income must be taxed to him who earns it." Is the finding in Armantrout any different, as a matter of fact, from what we have here?

MR. TESCHNER: Much different.

THE COURT: How different?

[A175]

MR. TESCHNER: Well, it only covered a few key employees and these key employees were shareholders, much like Grant Jacoby.

THE COURT: That wasn't the basis of the ruling on the tax court or the circuit, was it?

MR. TESCHNER: The testimony of the employees was equivocal in Armantrout in that they never made a statement one way or the other that they could not have bargained to have received more compensation.

THE COURT: Let's talk a little bit about bargaining, O.K.? I have asked Mr. Wheeler some questions about how Mr. Young questions, about how recommendations were made for inclusion in the plan. He said the manager of each division would make recommendations, then the management of the parent corporation would approve or disapprove. This was under the yearly budget submission. Now, the best I can tell, it was basically the big wheels in each of the subsidiaries who got to participate.

MR. TESCHNER: Yes.

THE COURT: How is this lack of bargaining, how did that actually work in

practice? The manager or the editor of the Hagerstown newspaper got into the plan. Was this an accident? Did he bargain with himself?

MR. TESCHNER: I don't know. I spent 18 years in a large law firm and there are all sorts of ways you evaluate

[A176]

associates. Sometimes I would evaluate them if they were entitled to more compensation at the end of the year because I found they were better helpers than other associates. I don't know, but the question is did the individual employee parent have any bargaining rights and as far as I know they didn't. I think the testimony was quite clear on that point.

THE COURT: What does it mean to have bargaining rights?

MR. TESCHNER: Well, they didn't bargain.

THE COURT: It is just something that happened, one day we got a letter saying congratulations?

MR. TESCHNER: That is what they testified.

THE COURT: I realize that is what they testified. I always have to believe what they testify.

MR. TESCHNER: Well, I have seen these letters. I know that is what happened. This at first was controlled very closely by Mr. Schurz himself, then by the board of directors.

THE COURT: Do you think when they got these letters it might have caused them to press less hard for raises that they might be requesting?

MR. TESCHNER: I don't know. Mr. Wheeler made $75,000 in 1975. I think

that was a very good salary. I don't believe so.

THE COURT: Do you think they were happy with those

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salaries before and it didn't cause them to be less interested in raises?

MR. TESCHNER: I think so.

THE COURT: Does that make sense?

MR. TESCHNER: It does to me.

THE COURT: Because of this, maybe they don't have to worry about college expenses as much, maybe they don't have to salt away as much in the old bank account and they become more cooperative, they aren't always hounding you for an extra dollar.

MR. TESCHNER: What I know about good employees is that they are always after more compensation.

THE COURT: Well, that being the case, do you think that getting one of those letters out of a clear blue sky without any invitation would not make a man less hungry or less likely--

MR. TESCHNER (interrupting): - Well, they didn't testify to that today, but they told me that. They didn't know about it. Mr. McLaughlin said he didn't know of the other people who were having children in the EDUCO plan.

THE COURT: Well, it didn't matter whether he knew whether anybody else did, but just so long as he knew he was on board, do you think that next time he wanted to ask for a raise he might have refrained, he might have felt, gee, maybe they have already been good enough to me, maybe my

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expenses aren't quite as large as I

thought they would be, I have got this benefit and I will ask for less, I will be more cooperative, maybe I will delay asking for a raise, don't you think that would have happened?

MR. TESCHNER: I don't know. I have enough difficulty reading my own mind without reading other peoples. It depends on the employee, I guess.

THE COURT: Well, I think the problem I am having with your position is that you treat this letter as an isolated event that had no conceivable precursors and no consequences, it comes in the context of an on-going employment relationship. The employer would at the very least have to know that this employee had children, children that might cause a burden as far as college goes.

MR. TESCHNER: Well, just go to the personnel department and determine

THE COURT: Well, somebody has to think about it, somebody has to get the idea. Employees are known to drop those hints. They stop in at the manager's office and say, oh, George, I am so worried about college for my children, money just doesn't go as far as it used to. Now, has the employee bargained for anything? Who can tell. We are talking about an ongoing employment relationship. We are talking about a series of benefits and compensations remunerations which make up the total package of what it takes to

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keep employees from leaving, keeping them happy and productive.

MR. TESCHNER: Now, this case only involves these two employees. They testified that they did not bargain.

THE COURT: I understand they testified they didn't bargain. I guess the question is what does it mean to bargain. Do you bargain when you sit across the bargaining table with a mediator from the Federal Mediation Service or is it bargaining when an employee's contact is much more subtle.

MR. TESCHNER: Yes, I would think so.

THE COURT: So what does it mean when you say they didn't bargain for it?

MR. TESCHNER: Well, sometimes you have to use words and just assume that they have common meanings. To me bargaining means to sit down with somebody and just say how about a raise.

THE COURT: And they say, no, we can't give you a raise, but maybe we will get you in on the plan, stick in there and something good will happen to you in the future. Is that bargaining?

MR. TESCHNER: I would think it was bargaining, yes.

THE COURT: The employee didn't ask for it, but he left the office and went home and said he didn't get his

[A180]

raise to the little woman, but he gave me one of those looks and said, "You know, you probably won't have to worry much about college expenses as much as you think." Is that bargaining? Even though it happens all the time in an employment relationship. There is a real goodie out here that management can give away and seem to be using it to randomly give people without at least some implicit bargaining?

MR. TESCHNER: Well, there are all sorts of fringe benefits for which employees bargain, corner offices, first-class air travel, three martini lunches,

members of Congress to have their home office expenses paid, there are all sorts of these benefits.

THE COURT: That is not a fringe benefit, that is a service to the voting public.

MR. TESCHNER: Well, that is debatable.

THE COURT: Not with me. I didn't get a chance to vote on that.

O.K., Mr. Teschner, I think I understand your position. Anything Further?

MR. TESCHNER: No.

THE COURT: O.K. Thank you.

Mr. Philpott.

MR. PHILPOTT: Thank you.

May it please the court, I would like to take just

[A181]

a minute to clear up maybe three factual problems.

THE COURT: O.K., that is a good place to start.

MR. PHILPOTT: We have been discussing First Security and Basye. The Supreme Court in Basye in 1973 did not find its 1972 First Security case a roadblock to its decision in Basye.

Point 2, Mr. Teschner said that the Court in Armantrout, Judge Goffe, explicitly stated that the employees could have bargained. I consider Armantrout, both the court below and the circuit court, required reading in this area and I do not find that language in there. I find on Page 1001 of Judge Goffe's opinion, "Compensation of key employees who did not have children was not increased to compensate for the fact of the EDUCO plan payments on those employees with children." That, coupled with Your Honor's point gleaned from

the Seventh Circuit, I think, answers that question.

Thirdly, the 1979 Act on economic fringe benefits, two weeks ago President Reagan signed the Tax Reform Act of 1984. It included economic fringe benefits provisions in effect that put a moratorium on the Commissioner saying don't touch this area until December 31, 1985, a year and a half from now, until the Congress can study it further. It gave a hint as to what it is going to do. I frankly think this is irrelevant, but just to clear it up it listed five areas.

[A182]

All these were non-cash, non-cash, non-cash items. What are we going to do with these non-cash items? Employee discounts, no additional cost services. For example, a recreation room. Working condition

fringe benefits and diminimus fringe benefits. Things that are so triffling that we can't clog up the administration of the Internal Revenue laws to consider them.

THE COURT: Working condition fringe benefits like large offices?

MR. PHILPOTT: That is still under consideration. The case that we are deciding, these are cash benefits. These are $2,000 items and, as we said in our brief, if you have four children, which is possible under those enrollment schedules, this could come up to $32,000 for one of those employees. These are not what we call diminimus economic fringe benefits. I submit that it is a waste of time to consider economic fringe benefit loss in the Wheeler case.

THE COURT: Of course they are not benefits to the employee directly, they are benefits to the children.

MR. PHILPOTT: Well, as Your Honor pointed out a few minutes ago, you heard the testimony of the Plaintiffs when I asked them if they did not have these payments would they have paid for the college education expenses of their children and they said yes. Any time you have less out-of-pocket expenses, I think you have an economic benefit.

[A183]

THE COURT: So does it really turn on the generosity of the parent as to whether or not this is income? What if Mr. Wheeler came in and said, "I think any education above ninth grade is a waste of time. I would never have helped my son Duncan." And the other one. Anyway, waste four more of his years in college. Would that--should the case, then, in your view, have gone the other

MR. PHILPOTT: Coupled with the fact that Duncan did get payments?

THE COURT: Yes, Duncan did get payments.

MR. PHILPOTT: I would still submit that is income and we have to go to Judge Goffe's comment. We have to be realistic and exercise common sense what is the context that these payments are arising out of.

THE COURT: What I heard you to be arguing is that Mr. Wheeler and Mr. McLaughlin had said they would have made the payments anyway. I thought you were basing your argument on that fact.

MR. PHILPOTT: I was going to the concept of economic benefit. Any time that I think that you have less out-of-pocket expenses you have an economic benefit, but coupled with what Judge Goffe says, "We must nevertheless take

cognizance of the context in which such a benefit accrues." He was saying even perhaps familial satisfaction isn't enough per se to put this in the income dragnet, but we

[A184]

have to look at the ongoing employment relationship, which you referred to, and whether the parent likes the child or not, if the child received these payments in connection with the performance of these services, we submit it is income to the parents.

Early this morning Mr. Teschner said that he disagreed with our theory that either Section 61 or Section 83 would apply and, again, I think it is irrelevant, but just to set the record straight in Footnote 4 of the Seventh Circuit in Armantrout, and in the December 1983 Saunders

Fifth Circuit decision, the Circuit Judge Pulitz said, "The tax court concluded that the income was taxable to the physician under either Section 61 or 83. We agree and affirm." It doesn't matter, 61 or 83. 83 does not--

THE COURT (interrupting): Doesn't 83 give you problems with this?

MR. PHILPOTT: 83 is relevant only in a deferred compensation context. Mr. Teschner, as I heard him, was implying that Section 83 only applies to the restrictive stock options. In our last brief we put in our appendix the language of Section 83 and it doesn't contain that. In Greensboro the taxpayer suing for a refund was an employer. It wanted a current 162 deduction. The Internal Revenue said these are expenses, yes, you can have your deduction when the trust pays the expenses. In Greensboro

[A185]

these were doctors with little, bitty children, two and three years old, four year old. The Service was not going to deny Greensboro a deduction, but it was a question of timing. The Judge, we submit, came to the right conclusion and the Tax Division believes that the Federal circuit was wrong in failing to appreciate--

THE COURT (interrupting): It doesn't matter why they were wrong, if they were wrong. The point is they are a circuit and we have to take it.

MR. PHILPOTT: On the deduction 162 question.

THE COURT: And they know all the inferences that come from the ruling.

MR. PHILPOTT: As we have seen today, Judge Kashiwa in a footnote said he would not reach the income question. It wasn't

before them and we don't know what they would do, then, on that income question.

THE COURT: Let's go to the mechanics of this case again. Let's look at Duncan Wheeler. He became eligible for college in June of 1978 and for payment up to $8,000.

MR. PHILPOTT: Yes.

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THE COURT: I meant to say 1975 and I am looking now at Exhibit 27.

On June 1 of 1975 -- why don't you tell me the mechanics. What happened on June 1, 1975, as best we know? Who paid what to whom on that date, if anything?

MR. PHILPOTT: If I understand these enrollment schedules, coupled with the Exhibits 23 and 25, Mr. Wheeler had one

child, he would be eligible to go to college on June 1, 1975, and the plan anticipates regular four-year curriculum. So the maximum he would be allowed in the future would be $8,000.

THE COURT: Well, I understand what the plan was.

MR. PHILPOTT: If you look down on Elizabeth McLaughlin, it would appear that she is two years out.

THE COURT: I understand that.

What I am saying is, what payment was made to whom in 1975 with respect to James D. Wheeler?

MR. PHILPOTT: In our contentions of facts and in our admissions the plaintiff has admitted that in the calendar year 1975 --

THE COURT: Where is that?

MR. PHILPOTT: Western Michigan --

THE COURT: Request for admission.

MR. PHILPOTT: Nos. 44 and 45, I believe.

THE COURT: Well, 42 and 43 maybe.

[A187]

MR. PHILPOTT: Nos. 42 and 43.

THE COURT: O.K. Let me go through that.

MR. PHILPOTT: I believe Western Michigan University was paid $2,000 in each of those years.

THE COURT: Actually what I would like to understand is when did South Bend Tribune pay anything to Educo with respect to Duncan Wheeler?

MR. PHILPOTT: On this document you cannot tell. You can tell that they paid $26,100 on enrollment schedule No. 1, payment period June --

THE COURT: Yes, I am looking at that.

MR. PHILPOTT: These are projections --

THE COURT: Before June 1, 1975. So assume they paid $26,100 before June 1, 1975, on the assumption that Duncan Wheeler would go to college.

MR. PHILPOTT: Well, and all of the other children too, not just Duncan.

THE COURT: Yes, I understand, but it includes the assumption Duncan Wheeler will go to college.

MR. PHILPOTT: Yes.

THE COURT: Now, the college year extends over two calendar years, 1975 and 1976.

MR. PHILPOTT: Yes.

THE COURT: Actually you are saying that the payment from South Bend Tribune to Educo occurred in 1975 and

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that the payment from Educo to, on behalf

of Duncan Wheeler was also made entirely before December 31, 1975?

MR. PHILPOTT: Or accrued.

THE COURT: How would it accrue?

MR. PHILPOTT: They give notice that Duncan is in school and will be eligible for $2,000 for that year.

THE COURT: Maybe he doesn't have $2,000 in expenses. In fact, he didn't in 1975.

MR. PHILPOTT: They would only pay on disbursements when they get the correct bills and, as a matter of fact, that's the maximum allowable. If there is a bill of $1,235 they would only get --

THE COURT: What if a bill came in, you know, say it got delayed, Western University is slow and the tuition bill doesn't go out until January of 1976, so that although Educo got its money on June of 1975 it doesn't start making out a

payment for the benefit of Duncan Wheeler until January of 1976, when would you contend that the income to Mr. Wheeler took place.

MR. PHILPOTT: At the time the college is paid.

THE COURT: So under that scenario he would not have income in 1975, under your theory, but the income would be in 1976?

MR. PHILPOTT: That's right.

THE COURT: So you are allowing basically upon

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the request for admissions and the table at Page 4-A to say that payments must have been made before December 31 of the school year. So that the payment was made of 1,282.50 for 1975, in 1975, and 476 in 1976?

MR. PHILPOTT: Yes.

THE COURT: Although the school year of 1976 continued halfway into 1977?

MR. PHILPOTT: Yes.

THE COURT: And as to Ms. Ann Wheeler we have a similar chart and essentially stipulated that the payments were made before 1975 and then 1976 expired?

MR. PHILPOTT: Yes.

THE COURT: Mr. Teschner, do we have any dispute on that point?

MR. TESCHNER: No.

THE COURT: O.K.

But your position, Mr. Philpott, would be that if some of the money had been paid out of trust the next calendar year would be contending that the income to the employee would have occurred when the money was actually paid out of trust?

MR. PHILPOTT: That payment then -- we respect every calendar year or taxable

year and there is no dispute here among the parties about wrong taxable periods, but you are quite right to --

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THE COURT: I just wanted to be sure that that was, what your position was on that point.

What do you say about the -- argument?

MR. PHILPOTT: As I said before, the more I read Judge Goffe's opinion in Armantrout, and this is an honest statement, I think he really went into everything that that we need to know about this question.

Equal protection argument I guess is a polititcal question. He raises it in the terms of Section 117-3 -- excuse me, let me back up again.

Today they have been talking about

scholarships, scholarships. None of these cases, none of these 10 decisions talks in terms of these being scholarships and I think we have besmirched the language when we call these things scholarships. I want to briefly go into Johnson versus Binzler, Justice Stewart's decision in 1973, the first decision under 117, what is a scholarship.

Now, Justice Stewart at Page 751 of Volume 741 of U. S. Reports -- I regret I didn't put these in my brief --

THE COURT: Justice Stewart has a way with words.

MR. PHILPOTT: "Here, the definition supplied by the regulation, clearly a prima facie proper, comporting as they do with the ordinary understanding of scholarships", as relatively disinterested, no strings educational grants with no requirement of any substantial quid pro quo. That's

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how I view scholarships. That's how Justice Stewart views them.

THE COURT: Is there a word stipend, something that tends to offend you?

MR. PHILPOTT: Pardon me?

THE COURT: Stipend.

MR. PHILPOTT: Payment, stipend.

THE COURT: Is that a word that offends you, as well?

MR. PHILPOTT: But you brought up an equal protection argument and the way plaintiffs are bringing that in through the door of Section 117-3-A, where there is a particular sentence, the third sentence of that regulation which goes to tuition remission grant.

Now, Congress makes the law. That is a specific provision in Section 117. The Commissioner didn't make it. It has to do with educational institutions

where, if I were employed by Purdue, as a Professor, and participated in a tuition remission program, I want to send my daughter to Western Michigan University and they participated also in a tuition remission program I could enroll her in that and there would be no exact amount paid to her, would not be included in my income.

THE COURT: Sounds like quite a deal.

MR. PHILPOTT: That's quite a deal, but that's the

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way Congress has set it up, as we explained in our brief.

THE COURT: I am not sure I understand your explanation. You are talking about university balance sheets and all sorts of things of that sort and I'm not sure I understood.

MR. PHILPOTT: There was a--many years ago in Greensboro in a tuition remission grant program. You had a college professor sending a child, a faculty member sending a child --

THE COURT: Let's not even talk about other schools.

Let's say that you have a university that says all faculty members may send their children to school here for nothing, whereas we charge everybody else $4,000 in tuition for a year.

Now, why isn't that as good as money in the bank? Why isn't that exactly like they have said we are going to give you $4,000 more in income and you all know professors are educated fools, they would never stand for having their children not go to college, so why isn't it just like that? Why wouldn't the service, but for that provision, be going out and saying this

is additional compensation?

MR. PHILPOTT: You are going to make me say things that I will regret, but I agree with you. I can only counter with all things are income unless specifically excluded,

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and this is specifically excluded.

THE COURT: I understand. I think we all understand--

MR. PHILPOTT: Free parking to a Chief Judge of the Claims COurt, which could amount to $1,500, $2,000 a year.

THE COURT: I take the Metro.

I understand. The question though is, we are talking about the same benefits. If you are going around suing people in my court or people bringing lawsuits in my court for parking benefits and IRS will say, yes, Your Honor,

you know, you really ought to sock it to these employees as income, but don't worry, we will not go after you, then we have a very serious problem, but the point is you are not really enforcing that as to anybody, whether they be government employees or nongovernment employees.

Mr. Teschner's point, I thought, was that here we have the identical benefits and that is the opportunity to have a college education at somebody else's expense, because we know there is no such thing as a free college education, it is merely a question of who pays for said college education.

In this case we have the payment made by South Bend Tribune. In another case we have the payment made by Western Michigan University. Why would the two tax payers

be treated differently because one of them happens to be employed by a newspaper, whereas the other one happens to be employed by an educational institution?

MR. PHILPOTT: In the educational institution situation you have a classroom of 25 people, say you fit two more in there on tuition remission grants, there is no direct payment of $2,000. The cost factors are different. Say you put five more, it's the same to the university whether they have twenty-five or thirty.

THE COURT: If you take --

MR. PHILPOTT: We are talking about the --

THE COURT: If you take that point of view --

MR. PHILPOTT: Here we have cash payments and the Tax Reform Act of 1984 hits hard on noncash versus cash.

THE COURT: Whatever happened to -- the economy and the travesties being committed by people swapping services with each other. Here we have Purdue University swapping with Western Michigan University and do they made cash payments that can be taxed honestly, like they ought to be? No. All they do is have little bookkeeping entries, just like those people do that are the Commission is always complaining about. You paint for me and I'll fix your car, which you all know is bad, bad, bad, because it is supposed to be income on both sides.

Now, why ought -- well, that's another question,

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why they ought to be treated differently, but why ought the law to allow under our

Constitution this unequal treatment, must there not be at least a rational basis for distinguishing between educational employers and other employers?

MR. PHILPOTT: I think the only basis we can come to is the fact of the cash payment here, the $2,000, which--

THE COURT: That is a very dangerous basis for the government to make a distinction, because once we start talking about cash payments the whole---economy, that then turns out to be your rationale, in an employment relationship then all these cases that you are hoping to bring concerning about the economy and we all know it, it's in the billions of dollars, are going to be--so you really don't want me to rule that that's a distinction, do you? I know you want to win this case, but surely not the cost of giving up trillions of dollars in tax

revenues by taxpayers who are bartering services for each other. You know about these barter clubs? I got a publication in the mail called "Tax Avoidance News". People are making money, big money selling through the mailways too, ways in which to avoid taxes.

Isn't this a serious question?

MR. PHILPOTT: I think it is a serious question, I think it is a political question and if you go into the documents Mr. Teschner submitted, the Commissioner did want to knock this exemption out, but there was a big hue and cry.

[A196]

THE COURT: Let's say that the Commissioner, oh, let's make--Congress had said, you can take a deduction for homeowner's interest unless you are

black, white, Chinese. Native American's can do it, but if you are not one of those you can't take deductions. That statute, if such a travesty should pass, that statute would [not] be upheld under the Constitution. I don't think there is any disagreement on that point.

MR. PHILPOTT: That's correct, Your Honor.

THE COURT: And that is because color or race is a--classification. The Supreme Court has told us again and again that sexual or sex rather is not a--classification so what if Congress passed a law that said male heads of households can deduct homeowner's mortgage interest, but females can't.

MR. PHILPOTT: This is still a blatantly impermissible distinction criteria.

THE COURT: The fact is that absent the passage of the Equal Rights Amendment, and we all know it has not passed,

at least it wasn't passed the last time I looked, the Supreme Court held again and again that sex is not a suspect classification.

To be sure, all of the equal protection cases where there has been success has involved male and female distinctions. You have Reed versus Reed and Weinberger

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versus Weisenfeld and Weinberger versus Weisenfeld was a social security benefits case, I believe, widows or widowers.

If we get away from these classifications like sex and race and the like and we get into geographics and they said anybody east of the Mississippi can deduct mortgage interest, but folks west of the Mississippi can't, something a little bizarre. There must be -- I realize that

when it comes to dispensing tax benefits Congress has a lot of latitude, but there must be come limit to that and the fact there is a hue and cry from the college professors doesn't hardly seem to me to be a confirmation, reason enough for us to say there was a rational basis.

MR. PHILPOTT: Your Honor, I have with me a copy of Duke University's tuition remission grant program, if you would like me to -- there are more limitations on it. I mean, just no body can get it. If you would like me to read it to you. I mean, it is not a great big boondoggle.

THE COURT: It's something. Some people get it.

MR. PHILPOTT: At Duke -- may I read it?

THE COURT: Sure, go ahead.

MR. PHILPOTT: "It is the policy of the University to provide tuition grants to the spouse and children of qualifying full staff members.

"One, eligibility.

"The spouse and children of a staff member whose

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position entitles him or her to benefit category No. 1 are eligible for inclusion in the tuition grant program.

"B A child," and I won't read the definition of child," or a spouse whose tuition is being paid under this program must be a full time student working towards a Baccalaureate Degree in an accredited college or university or an Associate of Arts Degree in an accredited junior college. In addition, for a spouse to be eligible under this program he or she must be enrolled at

Duke University or at a public institution in North Carolina only if the course of study is not offered at Duke or attendance at Duke is impractical because of geographic location."

THE COURT: It sounds good to me. I mean, something I would be happy to have. My child is not old enough to go to college, my wife is.

MR. PHILPOTT: I suppose we could put a cost on it, that it costs $50, a $50 benefit or a $2,000 benefit. We do have to come in, unfortunately, as the Congress has recognized, we do have to recognize what we are going to go after.

THE COURT: We are not talking about trifles. As you said, we are talking about a year's tuition. So let's just say there is no remission program. We are not talking about reciprocity

with any other school, we are just talking about the situation where there is a college professor that

[A199]

teaches at Duke and his wife decides she is going to go to college or his child and Duke is the best university around and so she goes to college there. They live in Durham, so where is she going to go? She's not going to go to Harvard. Obviously if he is teaching there they are living there so that is a convenient place for her to go. It is a fine university so she decides to go.

Let's say Duke normally charges $8,000 a year. Why, under what theory would we say that Mr. McLaughlin and Mr. Wheeler got $2,000 worth of benefits because $2,000 was paid to have their children go to college and say that the college

professor didn't get $8,000 worth of benefits because his wife or child decided to go to Duke, when everybody else has to pay $8,000. It's a tough position to be in for a government lawyer, right?

I mean, it is exactly the same case, it is exactly the same --

MR. PHILPOTT: We don't know the economics of it, Your Honor.

THE COURT: What?

MR. PHILPOTT: We don't know the economics of -- I mean, taking your hypothetical, I mean, if we did know the economics of that, if it's $8,000, that's --

THE COURT: Let's say everybody got charged $8,000. You don't mean to say that it is the cost to the

[A200]

employer that matters, so when an employer pays an employee with appreciated stock

the employee only gets 25 cents a share of income, because the employer bought AT&T stock in 1929?

MR. PHILPOTT: It matters very much in tuition remission, because in our case here we are having an employer take a deduction.

THE COURT: Yes, but we don't have a deduction case.

MR. PHILPOTT: It's just a matter of two colleges agreeing--

THE COURT: Let's not even talk about the colleges.

MR. PHILPOTT: That's the only context it can be raised in.

THE COURT: Just say it's one college and the college simply says your child can go to school here for nothing.

MR. PHILPOTT: I would tell the Commissioner to go after that. It is

not excluded. What is excluded is a tuition remission thing. If you want me to read it--

THE COURT: So under that plan, if the wife decided to go to Duke, as opposed to going to another school, the husband would get taxed for the full cost of the tuition?

MR. PHILPOTT: I would advance that position. The

[A201]

only thing I would not advance as being -- because the law provides if an educational institution maintains or participates in a plan whereby the tuition of a child of a faculty member of such institution as remitted by any other participating educational institution attended by such child the amount of the tuition so remitted shall be considered to

be amount received as a scholarship and, therefore, exempt. It is very narrow, there is no corresponding deduction side where, you know, the Treasury is being tapped twice.

THE COURT: Let me just understand here what you are saying.

Under that plan the wife of a college professor actually goes to Duke, doesn't go to another university, actually goes to Duke and Duke charges $8,000 a year tuition for that curriculum to anybody else, you take the position that the husband, who is the professor has $8,000 worth of income added to his salary and for tax purposes, that increases his salary by $8,000 during the tax year?

MR. PHILPOTT: I would.

THE COURT: And you are saying there is nothing about that regulation that's--

MR. PHILPOTT: Just--

THE COURT: But, if she goes to North Carolina and it is exactly the same deal--

MR. PHILPOTT: Reciprocal.

[A202]

THE COURT: But if it is reciprocal nothing would be added by way of income, because of that provision?

MR. PHILPOTT: Whether I agree with it or not I would have to say--

THE COURT: And you think there is a rational basis for the distinction?

MR. PHILPOTT: Yes.

THE COURT: What is that rational basis?

MR. PHILPOTT: There is no--deduction being given, on the one hand, for example, Greensboro wanted the deduction from income and then there is

no corresponding inclusion in income. Here we have South Bend giving current 162--there is no dispute about that. Then there is the symmetry of including that in income and that's the beauty of the Congressional plan, 61, 83, 162 and 404, the symmetry there. Income to one, in the year it's paid, deduction in the year it's paid.

THE COURT: But the situation of the wife is going to Duke and they are providing a free space for her without tuition would the school be able to take a deduction for the amount of the tuition?

MR. PHILPOTT: There is no income. There would be no deduction.

THE COURT: Let's say she is going to Duke for free.

[A203]

MR. PHILPOTT: They're not paying income taxes. What would they deduct. They have 20 people in the classroom and there is the twenty-first one in there, they are not taking any kind of action that is noticeable income tax-wise with regard to that twenty-first person.

THE COURT: Well, the seat, it takes up the space of somebody else who might have paid tuition.

MR. PHILPOTT: We all have -- I mean, reasonableness in this area. You can't pack up a classroom that is fit for 20 people with 80 freeloaders in there. The whole tax code has got to be read.

THE COURT: I can't understand your argument. What is the rational basis?

MR. PHILPOTT: It is the corresponding, the correspondence, the symmetry, the statutory symmetry.

THE COURT: But there are lots of situations where the employer might get the deduction at all and yet the--the employee has income.

MR. PHILPOTT: I would think that in the tuition remission program, if these colleges were getting tax breaks because of this I don't think Congress would allow it not to be includable.

THE COURT: So you think this is because colleges are nontaxable entities?

MR. PHILPOTT: I think it is the promotion of

[A204]

education, which is a worthy goal and we don't say that's not a worthy goal here in Wheeler.

THE COURT: Or McLaughlin.

MR. PHILPOTT: And McLaughlin.

THE COURT: Anything further, Mr. Philpott?

MR. PHILPOTT: I think that the bottom line, so to speak, of what Mr. Teschner has been advancing in all these cases -- incidentally, you may know that he was counsel in Educo, Inc., he was counsel in Armantrout, he was counsel in Gramt Jacoby. I'm not saying he has a right to come to every forum he wants to, but the bottom line he seems to speak is, well, because Mr. Wheeler couldn't have the payment himself then I can have any kind of cash benefit paid by my employer. Well, Basye puts that to rest and if this Court should chip away at what Basye and everything from Lucas v. Earl on down, income is taxed to him who earns it, we can have the South Bend Tribune making payments to Mr. Wheeler's elderly parents, in a nursing home, and they could set it up, say they want to be motivated, they

want to make satisfied employees. They could set it up in such a fashion that Mr. Wheeler never saw that money, but it was paid to take care of his elderly sick parents. We could have all kinds of possibilities of tax avoidance in these deviations from the assignment of income doctrine. I think that is basically the case that,

[A205]

he is trying to say, well, I have no right to receive it, you can't tax me on it and we say it is an ongoing employment relationship, these are part and parcel of the package.

If Mr. Wheeler quit for greener pastures his children couldn't get future benefits, only up to that point. If he should be fired, the same thing, Paragraph 7 under the agreement, but if he

should resign, as an ordinary employee does or if he should become disabled his children would be able to take all their benefits, if they got the payments.

We urge you not to accept the invitation of the plaintiffs to chip away at the bedrock principal.

Thank you.

THE COURT: See all the benefits of a flat rate tax? It would do away with incentives.

MR. PHILPOTT: I could go for a tax code that is one paragraph.

THE COURT: Mr. Teschner, anything further?

MR. TESCHNER: Thank you, Judge.

There are four points I would like to make, starting with Mr. Philpott's final point.

When I was in law school I learned what was sometimes known as the Lord Abinger reaction. Lord Abinger was an old English judge and he felt, at first, that he should decide a case in a certain way, but then he started thinking, my God, if

[A206]

I decide this case, this is going to happen, this is going to happen, this is going to happen, this is going to happen, and I just don't think the Lord Abinger reaction is a good way to decide a case.

The tuition remission programs, it seems to me to say the symmetry justifies the difference in treatment between college faculty members and other employees, really these schools are tax exempt and they get to deduct everything. They pay nothing in taxes. So if you are

talking about symmetry, here you have a tax exempt organization and you have no income on the other side, the Department of the Treasury set forth its reasons for withdrawing its tuition remission programs and that appears in Volume 42 Federal Register No. 11, on Monday, January 17, 1977, at Page 3181, and they said tuition remission programs, withdrawal of notice of proposed rule-making. Purpose. The purpose of this document is to withdraw the notice of proposed rulemaking relating to the treatment of amounts received under tuition remission programs for purposes of Section 117 of the Internal Revenue Code of 1954, which appeared in the Federal Register on November 2, 1976, 41 FR 48132.

On January 7, 1977, a public hearing was held on the proposed regulations.

Testimony presented at that hearing, as well as written statements submitted previously and thereafter, pointed out problems associated with changing

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the tax treatment of amounts received under tuition remission programs. In view of these problems and the joint study of the tax treatment of scholarships and fellowships, called for by the House and Senate Committee Reports on the Tax Reform Act of 1976, it has been concluded that notice of proposed rule-making should be withdrawn.

Accordingly, at the direction of the Secretary, the notice of proposed rulemaking on tuition remission programs is hereby withdrawn.

Now, they refer only to problems

concerning all tuition remission programs. They don't refer to certain problems of tuition remission programs, which schools and colleges give.

The second point I would like to make is, I admit that Section 83 was taken out of context. Certain language of Section 83 was taken out of context, which is that wherever one person receives amounts attributable to the services performed by another that amount shall be taxable to the guy who performs the services.

Now, the case which held Section 83 constitutional is Miriam Sakol, which appears at 67 Tax Court 986 and there, in [illegible] Judge Goffe, I believe, who is the same Judge Goffe, the same judge who decided the Armantrout case, said Section 83 is the Congressional response

to certain tax advantages, which could be obtained through use of

[A208]

restricted stock plans to compensate employees. Then he goes on to say, he is quoting from Senate Report No. 91-552, 1969, 1969-3 CB 500, it is clear in this regards and I quote from that Senate Report.

"General reasons for change. The present law treatment of restricted stock plans is significantly more generous than the treatment specifically provided in the law for other types of similarly funded deferred compensation arrangements. An example of this disparity can be seen by comparing the situation where stock is placed in a nonexempt employee's trust rather than given directly to the employee, subject to restrictions. If an

employer transfers stock to a trust for an employee and the trust provides that the employee will receive the stock at the end of five years, if he is alive at that time, the employee is treated as receiving and is taxed on the value of the stock at the time of the transfer. However, if the employer, instead of contributing the stock to the trust gives the stock directly to the employee subject to the restriction that it cannot be sold for five years then the employee's tax is deferred until the end of the five-year period. In the latter situation the employee actually possesses the stock, can vote it, and receives the dividends, yet his tax is deferred. In the case of a trust he has none of these benefits, yet he is taxed at the time the stock is

[A209]

transferred to the trust."

So, I submit that aside from the language, which is probably unfortunate, the purpose of Section 83 was restricted to restricted stock option plans.

My final point is where this is apt to lead, the decision in favor of the government here. On March 23, 1962, this was in my brief, the Commissioner filed his reply brief in the Teschner case. It is believed that it included the Commissioner's first expression anywhere of his generation of income theory. This is Page 6, Reply Brief For Respondent, filed in Teschner v. Commissioner, Tax Court Docket No. 90023, and this is what the brief said, and I quote. In the language of the brief the government's first expression, as far as I know, the generation of income -- "Respondent's theory correctly stated is that whenever A receives something of value attributable

to services performed by B, B the earner is the proper taxpayer. Petitioners would attribute to respondent a theory both too broad and too narrow. Respondent's theory, correctly stated, would not tax the petitioner's income paid to their daughter, but attributable to services performed by a stranger, but would apply with equal force to the facts of the present case, even if the recipient were unrelated to petitioners."

So, if we are going to, in tying what I consider

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as a more significant principal than Mr. Philpott does, the generation of income theory into the, at least, Claims Court law, it seems to me we are going down a path which will have no ending, because if anyone who generates the income

by performing services on the basis of which somebody else receives amounts it is a limitless possibility. You can imagine all sorts of situations where somebody is going to receive amounts due to services performed by somebody else.

Those are my only points.

THE COURT: Thank you, Mr. Teschner.

Anything further, Mr. Philpott?

MR. PHILPOTT: On this last point I can't see where we are going to have a very honest dispute on generation of income. I mean, the children didn't generate it. If the children didn't generate it who did.

THE COURT: O.K. Anything else from anybody?

MR. TESCHNER: No, Your Honor.

MR. PHILPOTT: No, sir.

THE COURT: Well, as I see it we

have basically two issues. The tax issue and the Constitutional issue and I am going to deal with them separately because they raise separate concerns.

On the tax issue I am going to rule for the defendant, the government. I think the case is basically one--with the Armantrout case and I have read Judge Goffe's

[A211]

opinion and I have read the Seventh Circuit's opinion in that case and I agree with it. I don't always agree with what other courts hold, unless they happen to be courts that, whose authority is binding upon me I tend to make up my own mind. On the other hand I don't go out of my way to disagree with courts just to be contrary. It seems to me that

the position of the Tax Court of the Seventh Circuit is correct.

The basic principle of Lucas versus Earl is applicable to this situation.

I have heard testimony today that the employees had no control over the way benefits were paid out or who would become, which employee would become a beneficiary of this trust agreement or anything else and I don't dispute the honesty of the witnesses, I don't doubt it, I simply think their assessment of the situation is not realistic. We have a situation where the employer has an opportunity to pick and choose who will become a beneficiary of this trust arrangement. It is significant, although I am not sure it is dispositive, it is significant that only key employees, only certain employees were to become, included in the trust agreement, the trust

arrangement and only their children will become beneficiaries.

From the evidence it appears that these were key employees, employees at the highest level of operations and

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management and for them to say that there was no bargaining that went on, as to whether or not they received these benefits, simply is contrary to common sense and common experience. It interprets the term bargaining far, far--

An employment relationship between an employer and an employee is a continuing process. The employee provides certain benefits and services to the employer and the employer, in turn, provides a package of benefits, both monetary and fringe benefits to the employee. In the case of these employees over a number of years and the

degree to which the employee is satisfied with the package will determine how productive he is and how likely he is to remain an employee.

Now, the picture that the plaintiffs have tried to paint is that somehow this was a benefit that came down from heaven in a letter received in the mail one day and it had no effect upon their compensation, they could not have traded it in for anything else or they could not have excluded themself from it. This simply defies belief. The employer had to be aware of which employees had children, which were either of college age or soon to become of college age or they would become college age within a reasonable amount of time and there are many ways in which an employee can bring to an employer's attention concerns about college expenses, the need for ways to salt away money for

[A213]

college.

To be sure, not every parent thinks that college is important or crucial, but for middle class and for upper middle class individuals, as these plaintiffs obviously were, college has become more than a luxury. College for one's children has become, these days, a real necessity. Certainly something that every parent considers very carefully providing for his or her children.

Both of the plaintiffs testified that they were concerned about their children's college education and that they would have contributed to it, and did contribute to it, regardless of the payments made by Educo.

Again, this was not a plan where every employee was included. It included key employees and it strikes me as entirely unbelieveable that an em-

ployee or the employer rather would have included in the plan an employee unless the employer were convinced that the employee would consider it beneficial to him, so that if, for example, there is no evidence that any employee was included who did not have children. It would be useless, it would be no economic benefit to the employee, unless that employee had some children.

Similarly, if an employee had expressed some sort of disdain for college or for educational benefits or had expressed to his boss the view that children ought to earn

[A214]

their own way through college, because that makes them hardy and prepares them for life, that is a view that could easily be communicated within the office

and something that a supervisor or employer would take into account in deciding whether to give a raise or to include an employee within the plan.

Now, employees were aware of the existence of the benefit. They were aware of the fact that this plan existed and that they could, if they were in key position, become eligible for it and using common sense and experience it simply is unbelievable that knowing that this benefit existed employees did not find subtle and not so subtle ways of letting supervisors know when or whether this would be something that would be of an advantage to them.

It would be a little bit foolish and a waste of corporate assets for the employer to include somebody in the

plan unless the employer was convinced that this is something that really would be of benefit to the employee and hence would be an incentive for the employee to do his best and stay and to basically do all the things which the plan was designed to do.

The Supreme Court said in Basye, we really don't need to get into the nitty gritty of the mechanics of whether there was actual bargaining between the parties. The point is that we have an employer/employer relationship. The

[A215]

essence of the relationship is services on the one side, provided by the employee, an economic package of benefits provided by the employer, on the other side. It is presumed that the mix of the package received and the level at which this

sat was a result of implicit or explicit bargaining. People frequently fool themselves, they said, oh, I didn't bargain, no, it just came to me out of the blue, but things don't happen that way in reality.

So when we are dealing with an employee/employer relationship, when we have a payment made which, in fact, accrues to the actual benefit of the employee, in the sense that the employees here, in fact, were going to be paying the tuition or a portion of the tuition for their children and where the payment is substantial and there is just no doubt at all that the payment here was substantial, it has to be compensation.

Now, plaintiffs have made much of the fact that many, it really did not matter whether you were high up on the

payment scale and had a few children or you were low on the payment scale and had a lot of children. You've got to remember that this was not a plan where everybody was included. Where every employee was included. An individual decision was made by the employer, as to each employee. Presumably before deciding whether or not to include an employee in the plan the employer would look at the number

[A216]

of children and would have to calculate the economic benefit provided to that employee. So for example, if Mr. Powers or some employee had five children, in deciding whether or not to provide, to include him in the plan the employer would naturally calculate that they

could be exposed to five times $8,000 or thereabouts of payments, if all of the children went to, chose to go to college. They would have to look at how close, they would naturally look at how close each of the children were to college age and when the expenditures would actually have to be made. Having made their decision or having made a determination they would then look at the employee's salary and determine whether or not the economic benefit, by including that employee into the plan, would when added to the salary over-compensate this employee. I assume the decision was made that this would over compensate the employee and some other arrangement would be made. I also assume that once that particular individual's five children were included in the plan the employer

thought more carefully about giving raises in future years, since they had just managed to take off a significant load on this particular employee's mind, as far as providing for his five children's college expenses.

So the plaintiffs' argument that both high and low or high earning or low earning employees participated in the plan equally and that compensation received by a

[A217]

number of children that didn't have a relationship to each other, really would have much more force if this were a plan where everybody participated. Once the employer had the discretion as to whom to include or whom to exclude we really have the makings of an economic decision. The basis for making a deter-

mination on the basis of that particular employee's value to the company versus the expense of including him in the plan, as well as giving him other compensation, so I don't think that has a particularly significant fact, the particular facts of this case.

Now, this is not to say that this is not a good plan, it obviously is a plan that has worked. The South Bend Tribune apparently is satisfied with the results. It apparently has had the effect of maintaining employees, keeping them from leaving for competitors and there is nothing at all wrong with that. It sounds to me like it was perfectly legitimate and perfectly acceptable way for the South Bend Tribune to participate. The question is whether or not the result of that is to provide additional compensation to the employee in some fashion, which is

other than by payment of salary.

The Court rules that the payments made under these circumstances were like salary. In fact, it was additional compensation to the employees and, therefore, taxable income in the years in which they were paid out by the plan

[A218]

in or on behalf of the children of employees. This has been stipulated to be in the years 1975 and 1976, as provided in Exhibits 42 and 43. I don't think I need to read them into the record.

MR. TESCHNER: Your Honor, might I say at this point, the amount stated for, I think, Mr. Wheeler's child is something less than $2,000, but we have agreed and in our factual portions of

our memorandum we have agreed on $2,000 in each year for each of the two children. It is a little misleading.

THE COURT: O.K. Then it is $2,000 for each plaintiff and one child in each of the taxable years, each child drawing $2,000 a year in each of the tax years and, therefore, the income was $2,000 a year to each of the plaintiffs for 1975 and for each of the plaintiffs for 1976.

Now, that is the resolution of the tax question.

On the equal protection question, the Constitutional question is a much closer one, in my mind.

On the one hand, equal protection law is made largely by two classes of cases. There are the cases involving a suspect classification, such as race, national origin, whatever those other--

MR. PHILPOTT: Religion.

THE COURT: Religion. Thank you, Mr. Philpott. The suspect classification or the one quasi suspect

[A219]

classification and that is sex. So all the case is going in favor of the plaintiffs, that I am aware, involved either suspect classification or a quasi suspect classification.

On the same hand, the tax law of all areas of the law--provides the greatest latitude to Congress in drawing distinctions. By its very nature a tax code relies upon finely drawn distinctions which may not appear fair or may not appear sensible or may not appear appropriate to reasonable people or it may appear, it doesn't matter, but the point is that Congress has a significant degree of latitude in passing

laws, in drawing distinctions, and, if anything, that latitude is even broader in the area of taxation.

Those are arguments supporting the constitutionality of the provision.

The argument on the other side is that there must be a reasonable basis or rational basis and the Supreme Court has now backed off from that and a rational basis must involved some sort of governmental interest, which a court can understand and appreciate and that can be articulated in some sensible fashion.

I have a lot of trouble with the distinction drawn between the benefits afforded college professors and their families and apparently there are similar benefits afforded to the plaintiffs under this plan.

Nevertheless, I am going to rule in favor of the

[A220]

defendant on that argument, as well, because I think it is a pure issue of law, ought to best be resolved by Circuit. I, myself, have very serious doubts on the point, but too much law has passed between 1933 and today for the Court to lightly overrule a regulation which has apparently the full support of the Congress or, indeed, the direction of the Congress, simply because I can't seem to understand why it makes sense.

It is a very, very touchy, a very politically charged decision and it may very well be that the distinction is one that falls or must fall within the political arena for resolution.

I think it is a much closer question than the briefs on either side have really admitted or that the Armantrout court admitted by its one line statement at the very end of the Seventh Circuit opinion.

I have reason to believe that my ruling will be taken up to the Federal Circuit and, if that should happen, I would suggest that careful thought be given to briefing that issue. I think it is a much closer issue than the tax issue and, indeed, maybe that superior vantage point of an Appellate Court, with the benefit of judges who can confer amongst each other and draw upon their common experience it may very well be that they will have, they will feel that this is a distinction that cannot be drawn,

[A221]

but I am simply going to have to allow them to make the decision on that point. All I can do is offer my own doubt on the subject for such benefit or such advantages either side may wish to draw from that.

I understand this is an area of the law where the government or the Commissioner is not totally comfortable, having once taken the position that those benefits ought to be taxed and I don't quite know what position we take on appeal of the issue, but I think it deserves an airing. I think it deserves a fuller briefing than it has received here and a vigorous argument at the appellate level.

Mr. Teschner, you were about to say something?

MR. TESCHNER: Your Honor, I just have, I would like to ask Mr. Philpott one question about 117.

THE COURT: Yes, you go right ahead.

MR. TESCHNER: Thank you.

THE COURT: That is my ruling. Are there any questions that I can answer or any explanations that I can give.

MR. TESCHNER: Not from me.

THE COURT: Mr. Philpott?

MR. PHILPOTT: No, Your Honor.

THE COURT: I am not sure whether I am going to write anything in this case. It may very well be that when I go back and look at it I will decide that Armantrout said

[A222]

anything or everything I would have on the subject.

I assume if there is an appeal there will be an opinion from the Circuit, which will either follow or will

not follow Armantrout, which will let the world at large know what the position is in the Circuit, once that decision is issued.

MR. TESCHNER: I would think your opinion here, Your Honor, would be adequate. What about findings of fact, is that no longer required? I think there were findings of fact in your opinion that you just read and my point is--

THE COURT: I wasn't reading.

MR. TESCHNER: No, excuse me, I'm sorry.

THE COURT: I'm not sure what -- I don't believe in simple findings of fact and they don't need to be written. I have given you my thoughts on the subject and I think I held that this was income. I held there was implicit bargaining and it was part of the continuing employment relation-

ship and that I think I held it was an economic benefit to the employees. I'm not sure what else I would need to find.

If there is anything you would like me to find further I would be happy to do so, right now.

MR. TESCHNER: I just thought, Your Honor, that there would be some value in your opinion, which you didn't read.

[A223]

THE COURT: What I said is--

MR. TESCHNER: There were findings of fact in there.

THE COURT: Yes, instead of compensation.

MR. TESCHNER: But if we don't have it in the record how can we--

THE COURT: There will be a transcript.

MR. TESCHNER: Oh, there will be

a transcript?

THE COURT: Oh, yes. Everything you have said is on the record and there will be a transcript.

The question I was asking myself if whether I ought to write something separate and my inclination was, having seen Judge Goffe's opinion and having seen particularly the Seventh Circuit's opinion in Armantrout, that fairly covers my view of the law and rather than burdening laws all over the country with another piece of writing I thought that I would probably skip it. If the parties feel differently I will take that into account.

MR. TESCHNER: No. I thought you were going to exclude it from the transcript.

THE COURT: No, no. Nothing like that, sir.

MR. PHILPOTT: We have Saunders' opionion also, Your Honor, which goes along with Armantrout. So we have two circuits, holding that this is income holding that this is compensation. We have no other circuit on the

[A224]

other side. If the Federal Circuit disagrees with you then there will be a conflict for the Supreme Court.

THE COURT: If there was something I thought I could add to what has already been written I would do so, but since I am taking the same view taken by the Seventh Circuit I think we can live with that.

MR. PHILPOTT: Thank you very much.

MR. TESCHNER: Thank you.

THE COURT: Thank you, gentlemen.

(whereupon, at 5:50 p.m., the hearing was closed.)

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Certificate of Reporter

I, Kathy Walsh, reporter, hereby certify that at the time and place aforesaid, I did cause to be taken down and transcribed the proceedings in this case, including the questions propounded to and the answers given by said witnesses so call by plaintiff (or defendant); and that the foregoing record is a correct transcript of the proceedings and testimony so had therein.

In witness whereof I have hereunto set my hand this day of August 13, 1984.

/s/ Kathy Walsh

APPENDIX D

6 AUGUST 1984 ORDER OF THE UNITED STATES CLAIMS COURT

IN THE UNITED STATES CLAIMS COURT

FILED: August 6, 1984

WARREN G. WHEELER, JR., et ux., Plaintiffs,		
v.	NO.	412-83 T
THE UNITED STATES, Defendant.		
JAMES J. McLAUGHLIN, JR., et ux., Plaintiffs,		
v.	NO.	414-83 T
THE UNITED STATES, Defendant.		

ORDER

For the reasons stated on the record immediately following trial on August 1, 1984, plaintiffs are not entitled to recover. The clerk is directed to dismiss the complaints with costs to the prevailing party.

August 7, 1984

/s/ Alex Kozinski
ALEX KOZINSKI
Chief Judge

mkb

APPENDIX E

7 AUGUST 1984 JUDGMENT OF THE UNITED STATES CLAIMS COURT

IN THE UNITED STATES CLAIMS COURT

JUDGMENT

WARREN G. & JEAN M. WHEELER, JR. NO. 412-83 T

and

JAMES J. & MARY K. McLAUGHLIN, JR. NO. 414-83 T

v.

THE UNITED STATES

Filed: Aug. 7, 1984

Pursuant to the order of August 6, 1984, it was held that plaintiffs are not entitled to recover with the complaints to be dismissed.

IT IS ORDERED AND ADJUDGED this

date, pursuant to Rule 58, that the complaints are dismissed, with costs to the prevailing party.

Frank T. Peartree
Clerk of Court

Aug. 7, 1984 By /s/ Debra L. Samler
Deputy Clerk

NOTE: As to appeal, 60 days from this date, see FRAP 4(a)

APPENDIX F

1 JUNE 1975 AGREEMENT BETWEEN EDUCO INC., AND SOUTH BEND TRIBUNE

[Claims Court Exhibit 25]

AGREEMENT

This is an agreement made on June 1, 1975 between EDUCO, INC. ("Company") and SOUTH BEND TRIBUNE ("Employer") with offices at 225 West Colfax, South Bend, Indiana 46626.

Whereas Company is engaged in the business of administering employer sponsored college scholarship and medical expense plans for children of employees of participating employers; and

Whereas Employer desires to adopt the plan ("Plan") described herein for the benefit of children of some or all

present and future employees of the Employer and its subsidiaries for the purposes of retaining such present employees, of attracting future employees, and generally to increase employee loyalty to Employer.

NOW, THEREFORE, for good and valuable consideration, receipt whereof is hereby acknowledged, Company and Employer agree as follows:

1. Company agrees to administer the Plan described herein to provide funds for certain educational, medical, and related expenses of children (individually "Child" and collectively "Children") of some or all of the employees of Employer covered by the Plan, all under the terms and conditions hereinafter stated.

2. Employer hereby becomes a participant in the Plan and agrees to make

contributions to Company or, at Company's direction, to the Trustee hereinafter designated or to any Successor Trustee appointed by Company at the times and in the amounts set forth in each enrollment schedule (individually "Schedule" and collectively "Schedules") executed by Company and Employer. All such Schedules, when so executed are specifically made a part of this agreement.

3. Exchange National Bank of Chicago ("Trustee") has executed a declaration of trust, agreeing to hold and dispose of the funds contributed to it by Company from time to time (including income therefrom, if any) upon direction of Educo.

4. Company shall direct Trustee from time to time to pay, subject to and in accordance with the Plan and each schedule: (i) the educational expenses

(as hereinafter defined), and (ii) the uninsured medical expenses (as herein after defined), of the Child or Children named in said Schedule which shall be incurred while attending any institution of learning following completion of the twelfth grade, high school graduation or acceptance in such institution prior to completion of the twelfth grade in accordance with any accelerated course of study, whichever event shall occur first. An institution of learning shall be a college, university, trade, vocational, professional or graduate school which has a scheduled curriculum, a regular faculty and a regularly enrolled body of students in attendance at a place where activities are regularly carried on and directed towards the instruction or training of the individuals for the purpose of improving or developing his or her capabilities. (All such institutions are

herein referred to as "college" for simplicity of expression only and not for purposes of definition).

With respect to each Child, educational expenses shall include the following expenses incurred during attendance at any college:

(a) Tuition, registration and other fees payable to any such college;

(b) Rental of living quarters provided by such college or a reasonable allowance for same;

(c) Cost of meals provided by such college or by a club, fraternity, sorority or boarding house, or a reasonable allowance for such meals;

(d) Cost of books and educational supplies purchased in connection

with attendance at any such college;

(e) Such other expenses as, in the opinion of the Company, are necessary, reasonable and directly related to the education of such Child.

With respect to each Child, uninsured medical expenses shall be expenses paid for medical care, medical care, medicine and drugs, as those terms are defined in the regulations issued by the United States Treasury Department under section 213 of the Internal Revenue Code of 1954.

5. Company shall, upon receiving such information as is necessary from the Employer or any Child entitled to benefits, direct Trustee to pay the eligible educational and uninsured medical expenses of each Child covered by the Plan when any such Child shall be en-

college as a full-time student in good academic standing. In the event any such Child is placed on academic probation for either two consecutive semesters or three consecutive quarters, further disbursements for such Child's educational expenses shall not be made until Company receives a letter from the college stating that the Child is a student is in good academic standing. Company shall be entitled to assume in the absence of written information to the contrary from Employer that each Child covered by the Plan is eligible for educational expense and uninsured medical expense benefits and is a full-time student. Company, in directing Trustee to make payment of any of the items mentioned in Paragraph 4, shall be entitled to rely on the correctness and genuineness of any statement, bill, or other evidence received by Company

and shall be without liability for any errors in any such statement, bill, or other evidence. Neither Company nor Trustee in any way guarantees that the total educational and medical expenses of any Child covered by the Plan will not exceed the scholarship specified for such Child on the applicable Schedule or that the funds held by the Trustee at any time will be sufficient to pay such Child's scholarship. Company shall have no liability in directing Trustee to pay educational expenses, within the limitations set forth in Paragraph 6, in the order in which Company receives the information necessary therefor without regard to the adequacy of the remaining funds held by Trustee.

6. Each payment on bahalf of any Child covered by the Plan shall be for a minimum of $100.00 except at Company's discretion. Payments shall be limited

during attendance at college to the amount specified for such Child in the applicable Schedule. Any Child not attending college at the date of the Schedule covering such Child who does not use any of the funds available before reaching the age of twenty-one (21) years or within four (4) years after becoming eligible for scholarship funds, whichever occurs first, will thereafter be ineligible for participation in the Plan if Employer designates a replacement child after either period has elapsed. Any Child who has not made use of all the funds available during any school period may use such unused funds during any subsequent school term or may continue his education in post-graduate or other studies and such unused funds shall be employed for such purpose, provided that in any such case any unused funds shall not be available

for any such Child after he attains the age of 26 years.

7. If any Employee whose Child or Children are covered by the Plan shall cease to be employed by the Employer, it shall be the duty of the Employer to so notify Company. If such Employee ceased to be employed by the Employer by reasons other than death, disability or retirement then the Plan shall thereafter be inoperable for each such Child or Children. If such Employee ceased to be employed by the Employer by reason of death, disability or retirement then the Plan shall thereafter be operable with respect to each such Child or Children subject to all other Plan provisions.

8. If any Child covered by the Plan does not use the funds available within the period prescribed, the Employer may, at any time thereafter,

enroll a replacement Child to use such unused funds, apply such unused funds to the Children remaining enrolled in the Plan on a pro rata basis and/or apply such unused funds to the Employer's future payments. For purposes of the provisions of this paragraph, a replacement Child shall mean any child designated by the Employer without restriction or limitation except that said replacement Child must be a child of an employee of Employer at the time of said designation.

9. This agreement and the obligations of the Company set forth herein shall terminate, subject to the application of the funds held by the Trustee as herein provided, (a) if the Employer shall elect to terminate this agreement upon giving the Company not less than thirty days' written notice thereof, (b)

if the Company shall elect to terminate this agreement upon (i) failure by the Employer to make any payment required to be made hereunder to the Trustee in accordance with any Schedule and (ii) continuance of such failure for a period of fifteen (15) days after written notice to the Employer by the Company, (c) if there shall no longer be any Child or Children covered by the Plan, or (d) if the Company shall elect to resign as administrator of the Plan, except that, in the case of such resignation, the Company shall, upon the request of the Employer, designate any other party named by the Employer to continue this agreement and to perform such obligations in its place and stead and direct the Trustee to accept the directions of such other party with respect to the Trust in all respects, all in accordance with the provisions of the Trust Agreement.

10. Upon the happening of any of the events described in paragraph 9 hereof (other than the resignation of the Company as administrator of the Plan if a successor administrator is designated), any undisbursed funds which shall theretofore have been paid by the Employer to the Trustee (excluding funds designated for the Child or Children of any deceased, disabled, retired or terminated Employee for whom funds have been paid) together with accumulated net income, if any, attributable thereto shall be applied in the following manner: (a) first, to Company for all fees due and payable to date to termination and for termination expenses incurred prior to terminations; (b) next, to any unpaid educational expenses incurred prior to termination; (c) next, held by the Trustee for the future educational and uninsured medical

expenses of the Children then remaining enrolled in the Plan, on a pro rata basis; (d) next, if there be no Child or Children then enrolled in the Plan, to one or more Children who are children of an employee of the Employer, designated within ninety (90) days of termination by the Employer for the specific purpose of using the undisbursed funds; (e) next, if no Child or Children be so designated by Employer within such period, then to any entity organized and operated exclusively for educational purposes designated by the Employer, gifts to which would be deductible for federal income tax purposes; (f) last, if no such entity is designated, Company shall disburse such funds for scholarships at its discretion, or to the National Merit Scholarship Corporation.

11. Employer expressly acknowledges and agrees that payment shall be made to Company at Company's direction and that

Company shall render periodic bills to Trustee which shall cover administrative services rendered by Company and Employer hereby irrevocably directs and authorizes Trustee to make such payment from time to time upon request therefor from Company and without liability to Trustee. Company shall furnish Employer an annual accounting of the disbursements made by Trustee, and Employer shall conclusively be presumed to have approved such accounting unless it objects thereto within sixty (60) days after the receipt thereof. If Employer objects to any accounting, Company or Trustee shall obtain an audit by certified public accountants and such audit (and any distribution in accordance therewith) shall be final, binding, and not subject to question. If such audit shall be paid from the contributions made by Employer pursuant to each Schedule or

any income attributable thereto, and Employer hereby irrevocably authorizes Trustee to make such payments from time to time upon request therefor from Company. If such audit fails to substantially confirm such accounting, the cost shall be paid by Company.

12. This agreement shall be governed by the laws of the State of Illinois.

13. This agreement may not be assigned by Employer or Company without the written consent of the other, provided, however, that Employer or Company may assign this agreement to any corporation succeeding to its interests without first obtaining the consent of the other.

EDUCO, INC.

By /s/Pierce R. Whiteside
President

SOUTH BEND TRIBUNE

By /s/Wayne G. Wheeler, Jr.
Executive Vice President

Supreme Court, U.S.
FILED
DEC 20 1985
JOSEPH F. SPANIOL, JR.
CLERK

(2)

No. 85-668

In the Supreme Court of the United States

OCTOBER TERM, 1985

WARREN G. WHEELER, JR., ET UX., ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

CHARLES FRIED
Solicitor General

GLENN L. ARCHER, JR.
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15P

QUESTIONS PRESENTED

1. Whether amounts paid to college-age children by an educational benefits plan funded by their parents' employer are includible in the parents' gross income as compensation for services, where the plan is designed as an incentive to continued employment and is limited to key employees selected by the board of directors.

2. Whether the inclusion of such amounts in the parents' income denies them equal protection of the laws, where the tax laws exclude from gross income, as "scholarships," certain tuition remission benefits provided by educational institutions to the children of college faculty members.

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BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A25) is reported at 768 F.2d 1333. The oral opinion of the Claims Court (Pet. App. A168-A188) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on July 25, 1985 (Pet. App. A26). The petition for a

writ of certiorari was filed on October 21, 1985. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Petitioners Warren G. Wheeler, Jr., and James J. McLaughlin, Jr.,[1] were employed by the South Bend Tribune Corporation (South Bend) during 1975 and 1976 (Pet. App. A6-A7). In 1975, South Bend entered into an educational benefits plan agreement with Educo, Inc., under which South Bend provided funds for the college expenses of the children of certain of its key employees (*id.* at A7, A199-A214). South Bend made sufficient contributions to the plan to provide funds for the payment of $2,000 per year to each eligible child, with a maximum total payment of $8,000 per child. Payments were made from the trust fund directly to the child or to the child's creditors. The employee-parent had no right to receive any of the money in the trust or to control its disposition (*id.* at A7-A8). If an employee left South Bend, his children would no longer be entitled to benefits under the plan (*id.* at A8, A208).

South Bend adopted the plan as an employment incentive to obtain and retain key employees (Pet. App. A7-A8, A200). South Bend's board of directors selected the employees whose children would be eligible for the benefits. South Bend in 1975 designated only 16 high-level employees (out of its 800 or 900 employees) for participation in the plan (*id.* at A8).

During 1975 and 1976, the trustee of the plan paid $2,000 toward the college expenses of the Wheeler's son

---

[1] Petitioners' wives are parties solely by virtue of having filed joint income tax returns with their husbands for the years in issue.

and the McLaughlins' daughter. The Commissioner determined that these amounts were includible in petitioners' respective gross incomes. Petitioners paid the resulting deficiencies in tax and, following the denial of their administrative claims for refund, brought these refund suits, which were consolidated for trial in the Claims Court (Pet. App. A8-A9).

Ruling from the bench, the Claims Court (Kozinski, C.J.) followed the Seventh Circuit's decision in *Armantrout* v. *Commissioner*, 570 F.2d 210 (1978), which involved an almost identical Educo plan, and held that South Bend's payments to the children represented compensation to their fathers, and thus constituted income to the latter in the years in which the payments were made (Pet. App. A168-A183). The court noted that the payments provided a concrete economic benefit to the parent-employees, since those payments effectively reduced the parents' college-tuition bills by $2,000 annually (*id.* at A173, A177). The court concluded that, as a practical matter, a child's participation in the plan resulted from the implicit bargaining inherent in the employer-employee relationship, *i.e.*, that the payments were simply one component of the "economic package of benefits" provided by South Bend as compensation to Wheeler and McLaughlin (*id.* at A176-A177). The court accordingly held that the payments were "like salary" and were "additional compensation" properly includible in petitioners' income when paid by the plan to their children (*id.* at A182).

The court of appeals unanimously affirmed (Pet. App. A1-A25). It concluded that the payments received by petitioners' children under the Educo plan were "compensation for the services their fathers rendered to South Bend" (*id.* at A11). The court

observed that the payments conferred an economic benefit upon petitioners by providing financial support for their children's education, support that the parents themselves would otherwise have furnished (*ibid.*). The court found it irrelevant that South Bend did not bargain directly with its employees about the Educo plan, pointing out that benefits received under the plan "obviously were factors the company took into account in determining compensation" (*id.* at A13). The court also found it immaterial that the payments were made to the children and not to the employees themselves, relying on the fundamental principle that income must be taxed to the person who earns it—here, the children's fathers (*id.* at A14-A15).

The court of appeals also rejected petitioners' argument that inclusion of the payments in their respective gross incomes violated the equal protection component of the Fifth Amendment, an argument based on the fact that certain tuition remission benefits provided by educational institutions to the children of college faculty members are exempt from taxation as "scholarships" (Pet. App. A15-A25, citing Treas. Reg. § 1.117-3(a)). The court noted that Congress may provide tax benefits to a particular class of taxpayers, while denying similar benefits to a different class of taxpayers, if the classification bears a rational relationship to a legitimate governmental purpose (Pet. App. A17-A21). The court found several rational bases for the classification at issue here and accordingly rejected petitioners' equal protection claim (*id.* at A22-A25).

ARGUMENT

The decision below is correct. Contrary to petitioners' assertion, that decision is consistent with the decisions of every other court of appeals that has considered the question. There is no conflict with any decision of this Court and no other basis for further review.

1. Section 61(a)(1) of the Internal Revenue Code [2] defines "gross income" to include "compensation for services." This definition "is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected." *Commissioner* v. *Smith*, 324 U.S. 177, 181 (1945). The courts below correctly concluded that the payments to petitioners' children represented compensation for their fathers' services, since those payments were part and parcel of the compensation package that South Bend offered in exchange for its employees' labor. As the court of appeals observed (Pet. App. A13), South Bend treated the benefits paid through the plan as compensation to its employees; it adopted the plan as an incentive to encourage key employees to stay with the company, and it used the plan as a means of recruiting new high-level employees (*id.* at A7-A8, A13). From the parent-employee's perspective, payment of part of his child's college costs was obviously a valuable reward for services rendered. Since the payments conferred an ecoonmic benefit on petitioners in exchange for services rendered, those payments are includible in petitioners' gross income under Section 61(a)(1). The court of appeals' decision to that effect

---

[2] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect for the period at issue (the Code or I.R.C.).

is in accord with the decision of every other court of appeals that has considered the taxability to a parent-employee of payments made to children under educational benefits plans similar to that here. *Saunders* v. *Commissioner*, 720 F.2d 871 (5th Cir. 1983); *Armantrout* v. *Commissioner*, 570 F.2d 210 (7th Cir. 1978), aff'g 67 T.C. 996 (1977). Accord, *e.g.*, *Grant-Jacoby, Inc.* v. *Commissioner*, 73 T.C. 700, 706-710 (1980).[3]

Petitioners' primary contention (Pet. 6-9) is that they cannot be taxed on the payments in question because the money went directly to their children rather than indirectly to their children through them.

---

[3] Petitioners appear to contend (Pet. 9-10) that they received no "economic benefit" cognizable for federal tax purposes because they had no legal obligation to pay for their children's college education. The court of appeals correctly concluded (Pet. App. A11) that the absence of such an obligation is immaterial. As this Court has repeatedly held, gross income for federal tax purposes includes "*any* economic or financial benefit conferred on the employee as compensation" (*Commissioner* v. *Smith*, 324 U.S. 177, 181 (1945) (emphasis added)); an around-the-world-cruise provided free to an employee's family by his employer is an "economic benefit" even though the recipients are not legally required to travel. It is of course true, as petitioners note (Pet. 9-10), that an employer *does* confer an economic benefit on his employees when he *does* discharge their legal obligations. *E.g.*, *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716, 729 (1929) (employer's discharge of employee's income tax liability represents taxable income to the latter). But to deduce from that premise that an employer *does not* confer an economic benefit on his employees when he subsidizes their discretionary payments is to commit an error of logic. Petitioners' citation (Pet. 10) of *Commissioner* v. *Hansen*, 360 U.S. 446 (1959), is even more misplaced; that case involved the accrual method of tax accounting and had nothing to do with the taxation of compensation for services.

But this contention, as the court of appeals correctly observed (Pet. App. A14-A15), runs afoul of what this Court has described as " 'the first principle of income taxation: that income must be taxed to him who earns it.' " *United States* v. *Basye*, 410 U.S. 441, 449 (1973) (quoting *Commissioner* v. *Culbertson*, 337 U.S. 733, 739-740 (1949)). See *Lucas* v. *Earl*, 281 U.S. 111, 114-115 (1930). Under the assignment-of-income principle, a taxpayer "who earns income may not avoid taxation through anticipatory arrangements no matter how clever or subtle." *United States* v. *Basye*, 410 U.S. at 450. The fact that South Bend's plan was structured so that petitioners themselves had no "right" to the money (see Pet. 6-9), moreover, is irrelevant. "The [person] earning the income * * * cannot avoid taxation by entering into a contractual arrangement whereby that income is diverted to some other person," and the government in such a case "need not prove that the taxpayer had complete and unrestricted power to designate the manner and form in which his income is received." *United States* v. *Basye*, 410 U.S. at 449, 452.

Here, it is obvious that Wheeler and McLaughlin earned the income; it was they, not their children, who worked for South Bend. If South Bend had made the payments directly to the fathers as reimbursement for the college expenses they had incurred, the payments would plainly have been includible in the fathers' gross income, and "[t]he result should be no different because the company instead routed the payments * * * to the children" (Pet. App. A41). The court of appeals here, like the other courts of appeals that have considered this question (*Saunders* v. *Commissioner*, 720 F.2d at 873; *Armantrout* v. *Commissioner*, 570 F.2d at 212-213), properly relied on the

assignment-of-income principle in holding petitioners taxable on those payments.[4]

2. Petitioners' contention (Pet. 11-12) that the court of appeals applied an improper standard in rejecting their equal protection argument is frivolous. In *Regan* v. *Taxation With Representation*, 461 U.S. 540, 547 (1983), this Court reiterated the settled principle that "statutory classifications are valid if they bear a rational relationship to a legitimate govern-

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[4] There is no merit to petitioners' assertion (Pet. 7-8) that the decision below conflicts with this Court's decision in *Commissioner* v. *First Security Bank*, 405 U.S. 394 (1972). That case involved Section 482 of the Code, which provides that, "[i]n any case of two or more [entities] owned or controlled directly or indirectly by the same interests, the [Commissioner] may * * * allocate gross income [and] deductions between or among such [entities], if he determines that such * * * allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income." The Court held in *First Security Bank* that the Commissioner could not use Section 482 to allocate insurance commission income to one of a controlled group of corporations, where the corporation in question was prevented by federal law from receiving such commissions. However, as the Court subsequently stated in *United States* v. *Basye*, *supra*, the assignment-of-income doctrine had no application in *First Security Bank*, since "that case involved a deflection of income imposed by law, not an assignment arrived at by consensual agreement of two parties acting at arm's length" (410 U.S. at 453 n.13 (distinguishing 405 U.S. at 403-404)). The instant case, like *Basye* and unlike *First Security Bank*, involves an arm's-length employment relationship, not a deflection of income imposed by law. Petitioners' assertion (Pet. 8-9) that the decision below conflicts with *Bank of Coushatta* v. *United States*, 650 F.2d 75 (5th Cir. 1981), and with *Salyersville National Bank* v. *United States*, 613 F.2d 650 (6th Cir. 1960), is likewise without merit, since both of those cases involved the application to insurance commission income of the principles of *First Security Bank*.

mental purpose. * * * Legislatures have especially broad latitude in creating classifications and distinctions in tax statutes." As the court of appeals correctly held here, there are several rational bases for treating an educational institution's remission of tuition charges for faculty members' children, which under certain circumstances may constitute a tax-exempt "scholarship" (I.R.C. § 117(a); Treas. Reg. § 1.117-3(a)),[5] differently from an employer's direct cash payments to an employee's child. First, as the court observed, a tuition remission is a noncash benefit, and the "administrative difficulty in valuing such noncash benefits may be substantial" (Pet. App. A22). Second, the court properly noted that a tuition remission program is typically available to a broad category of employees, whereas the benefits in issue here were provided to a small number of South Bend's key employees, selected by the company's board of directors (*id.* at A23). Congress may rationally have decided to limit the "scholarship" exclusion to broad-based noncash programs that involve less risk of tax avoidance than do direct cash payments to children of selected high-level employees (see *id.* at A24). Fi-

---

[5] As the court below observed (Pet. App. A19), this provision in the Regulation was taken directly from language in the Committee Reports on the 1954 Code, which indicated that Congress intended the term "scholarship" to include such tuition remissions. H.R. Rep. 1337, 83d Cong., 2d Sess. A347 (1954); S. Rep. 1622, 83d Cong., 2d Sess. 188 (1954). In 1984, Congress codified and broadened the Regulation by providing an exclusion from gross income for any reduction in tuition provided to an employee of an educational institution for the education of the employee or the employee's spouse or dependent children. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 532, 98 Stat. 887 (adding I.R.C. § 117(d)).

nally, the court of appeals noted that "Congress could have reasonably decided to exempt tuition remissions for children of college faculty members as a way of promoting higher education by encouraging qualified people to enter and to remain in the academic teaching profession despite low earnings" (*ibid.*). Petitioners make no attempt to challenge the conclusion that the favorable treatment of tuition remission benefits bears a rational relationship to a legitimate governmental purpose, and there is accordingly no basis for further review of petitioners' equal protection claim.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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Attorneys

DECEMBER 1985

☆ U. S. GOVERNMENT PRINTING OFFICE: 1985 491507 20105

No. 85-668

Supreme Court, U.S.
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DEC 31 1985
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

WARREN G. WHEELER, JR., JEAN M. WHEELER, JAMES J. McLAUGHLIN, JR., And MARY K. McLAUGHLIN,

Petitioners,

v.

THE UNITED STATES OF AMERICA,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

PETITIONERS' REPLY BRIEF

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Goldberger's Estate, Commissioner v., (3d Cir. 1954) 213 F.2d 78, 81-82	4
Horst, Helvering v., 311 U.S. 112	2
Regan v. *Taxation with Representation,* 461 U.S. 540, 548	4-5
Teschner v. *Commissioner* (1962) 38 T.C. 1003, 1007	2,3

Statutory Provisions:

Title 26, U.S.C.: Internal Revenue Code of 1954:	
Section 61	1, 2
Section 482	1

Other Authority:

Andrew Mellon, *Taxation: The People's Business* (New York 1924)	6-7
Teschner, *Anticipation of Income,* 41 Indiana Law Journal 587-635 (1966)	4

IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

WARREN G. WHEELER, JR., JEAN M. WHEELER, JAMES J. McLAUGHLIN, JR., And MARY K. McLAUGHLIN,

Petitioners,

v.

THE UNITED STATES OF AMERICA,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

PETITIONERS' REPLY BRIEF

The Brief For The United States In Opposition ["Respondent's Brief"] asserts that the Petition should be denied for the following reasons:

1. There is no conflict between the Court of Appeals decision and the *First Security Bank* case [*Petition, pages 7-8, 13*] because that case was decided under Section 482 of the Internal Revenue Code ["Code"] whereas this case involves Code Section 61 under which Petitioners may be taxed as "earners" of income.

2. *United States* v. *Basye,* 410 U.S. 441, is directly in point and renders *First Security Bank* irrelevant.

3. *Regan* v. *Taxation with Representation,* 461 U.S. 540, allows differential taxation of corporate employees and no inquiry need be made to determine if the discriminated-against employees and the benefited employees are members of the same class.

It is Petitioners' unequivocal opinion that Respondent grievously errs in all three of those assertions.

ARGUMENT

I

In the *First Security Bank* case, both this Court [405 U.S. 394 at 406, fn.22] and the Tenth Circuit [436 F2d 1192 at 1197] cited with approval *Teschner* v. *Commissioner,* 38 T.C. 1003 (1962), *Commissioner's appeal dismissed on his motion* (7th Cir. Docket No. 14157, 1963); *non acq.* 1964-1 CUM.BULL. 6. That case arose from a contest situation where a taxpayer-father had entered an essay contest and, being unable to qualify for a prize under the contest rules, designated his seven year old daughter to receive any prize which his entry might win. His entry won a fourth prize and his daughter received a $1,500 annuity policy which was to mature when she reached college age. The Commissioner assessed a deficiency against the father under Code Section 61 on the theory that the value of his daughter's annuity policy was compensation to him. Respondent primarily relied on *Lucas* v. *Earl,* 281 U.S. 111 (1930), *Helvering* v. *Horst,* 311 U.S. 112 (1940), and his own *Rev.Rul. 58-127,* 1958-1 C.B. 42.

On March 23, 1962, the Commissioner filed his Reply Brief in the *Teschner* case. It is believed that it included the Commissioner's first expression anywhere of his "generation of income" theory [Page 6, Reply Brief For Respondent filed in *Teschner* v. *Commissioner,* Tax Court Docket No. 90023]:

> "Respondents theory, correctly stated, is that whenever *A* receives something of value attributable to services performed by *B*, *B*, the earner, is the proper taxpayer. Petitioners would attribute to Respondent a theory both too broad and too narrow. Respondent's theory, correctly stated, would not tax to petitioners income paid to their daughter, but attributable to services performed by a stranger, but would apply with equal force to the facts of the present case even if the recipient were unrelated to petitioners."

The Tax Court, in a fully reviewed decision, held for the taxpayers. Observing that income taxes are imposed upon "the income of every individual" and that where an individual neither receives nor has the right to receive income he is not the taxable individual within the contemplation of the statute, the court responded to the Commissioner's theory that "earners" are the proper persons to be taxed [38 T.C. 1003 at 1007]:

> "If by this statement the respondent means that income is in all events includible in the gross income of whomsoever generates or creates the income by virtue of his own effort, the respondent is wrong. If this were the law, agents, conduits, fiduciaries, and others in a similar capacity would be personally taxable on the proceeds of their efforts. The charity fund-raiser would be taxable on sums contributed as the result on income generated for his employer by his efforts. Such results, completely at variance with every accepted concept of Federal income taxation, demonstrate the fallacy of the premise."

II

Not even the most attentuated analysis of *Basye* would justify a conclusion that an income tax may properly be assessed against one who "generates" income but never has a right or power to receive that income in due course. The

question there was whether *Partnership* income—not the incomes of the individual partners—could be assigned away in advance of its receipt. Partnership anticipatorily assigned away its right to receive that income within the meaning of all of the Supreme Court cases on the point. See Teschner, *Anticipation of Income*, 41 Indiana Law Journal 587-635 (1966).

It is less than candid for Respondent to use Basye in this case to advance its "generation of income" theory. The fact that the partners in *Basye* might never have received anything from the Partnership retirement trust was irrelevant to the question of whether there was partnership income, chargeable to the individual partners according to their respective distributive shares. It is hornbook law that "[a] partner is taxable on his distributive share of the partnership's income whether he receives it or not, or whether he is aware of its existence." *Melvin L. and Sherry Gold*, 1983-711 TCM, ¶ 83,711 P-H Memo TC 83-2965, 83-2968, 47 TCM 458, 460 (1983). See also, *Commissioner* v. *Goldberger's Estate*, 213 F.2d 78, 81-82 (3d Cir. 1954).

III

Respondent cites only this Court's *Taxation with Representation* ["*TWR*"] case to support its assertion that Petitioners' equal protection argument is "frivolous". That decision, however, *did* apply a classification standard before it further inquired into whether there was a rational basis for the classification [461 U.S. 540 at 548]:

> "*** The sections of the Internal Revenue Code here at issue do not employ any suspect classification. The distinction between veterans' organizations and other charitable organizations is not at all like distinctions based on race or national origin."

A critical difference of the *TWR* case from this one is that this is an income-inclusion case while there *TWR* justified the differential taxation of veterans' groups from other charities "*** because it wants to use tax-deductible contributions to support substantial lobbying activities." *461 U.S. 540 at 543-544.* As *Petition page 12* points out: "Two important federal tax cases of this Court distinguish the different equal protection inquiries mandated by income-inclusion cases—such as this one—and deduction cases."

Petitioners challenge absolutely Respondent's assumption that they agree "*** that the favorable treatment of tuition remission benefits bears a rational relationship to a legitimate governmental purpose." *Respondents' Brief, page 8.* Even though he did not make a preliminary inquiry into the classification standard, Chief Judge Kozinski also did not accept Respondent's stated rationale [*Petition, page A140, A144-A145, A148-A149, A155, A-185-186*]:

> [A140] "Here we have Purdue University swapping with Western Michigan University and do they make cash payments that can be taxed honestly like they ought to be. No. All they do is have little bookkeeping entries * * * which you know is bad, bad, bad, because it is supposed to be income on both sides."
>
> [A144-A145] "I realize that when it comes to dispensing tax benefits Congress has a lot of latitude, but there must be some limit to that and the fact there is a hue and cry from the college professors doesn't hardly seem to me to be a confirmation, reason enough for us to say there was a rational basis."
>
> [A148-A149] "Let's say Duke normally charges $8,000 a year. Why, under what theory would we say that Mr. McLaughlin and Mr. Wheeler got $2,000 worth of benefits because $2,000 was paid to have their children go to college and say that the college professor didn't get $8,000 worth of benefits because his wife or child decided to go to Duke, when everybody else has to pay $8,000. * * *
>
> "I mean, it is exactly the same case, it is exactly the same."

[A155] "THE COURT: I can't understand your [equal protection] argument. What is the rational basis?

"MR. PHILPOTT: It is the corresponding, the correspondence, the symmetry, the statutory symmetry."

[A185-A186] "I have a lot of trouble with the distinction drawn between the benefits afforded college professors and their families and apparently there are similar benefits afforded to the plaintiffs under this plan.

"Nevertheless, I am going to rule in favor of the defendant on that argument, as well, because I think it is a pure issue of law, ought to best be resolved by Circuit. I, myself, have very serious doubts on the point, but too much law has passed between 1933 and today for the Court to lightly overrule a regulation which has apparently the full support of Congress or, indeed, the direction of the Congress simply because I can't seem to understand why it makes sense."

What chief Judge Kozinski regarded as a "pure issue of law" was transmuted by the Court of Appeals into a factual question. That Court then speculated as to the facts and found that those reconstructed facts—albeit not supported by the Record—justified the differential taxation here in issue.

Respondent's position that differential taxation of corporate employees is permissible if their employers' respective businesses differ necessarily rejects the fundamental principle of equal protection as a limitation on the taxing power. In point of fact, however, equality should be the *sine qua non* of any tax code. Andrew Mellon, in his book *Taxation: The People's Business* (New York 1924), warned of the consequences of applying class legislation principles to tax law [14 *The Annals of America* 446 (Encyclopedia Britannica (1968)]:

"I have never viewed taxation as a means of rewarding one class of taxpayers or burdening another. If such a point of view ever controls our public policy, the traditions of freedom, justice, and equality of opportunity, which are the distinguishing characteristics of our American civilization, will have disappeared and in their place we shall have class legislation with all its attendant evils. The man who seeks to perpetuate prejudice and class hatred is doing America an ill service. In attempting to promote or to defeat legislation by arraying one class of taxpayers against another, he shows a complete misconception of those principles of equality on which the country was founded.***"

CONCLUSION

The Petition For A Writ Of Certiorari should be granted.

Respectfully Submitted,

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